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THE DIRECTORATE FOR FINANCIAL, FISCAL AND ENTERPRISE AFFAIRS
PRIVATE SECTOR DEVELOPMENT UNIT**

BALTIC FORUM FOR ENTREPRENEURSHIP AND ENTERPRISE DEVELOPMENT

ENTREPRENEURSHIP AND ENTERPRISE DEVELOPMENT IN THE BALTIC REGION

POLICY GUIDELINES AND RECOMMENDATIONS

PUBLISHER'S NOTE

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Baltic Regional Programme

Centre for Co-operation with Non-Members

Foreword

The Baltic region is on the threshold of a new era. The resources of the region offer the prospect of a vigorous regional economy and sustainable progress in economic development. The governments of the region can play a significant role in fostering economic development and, in particular, the environment for entrepreneurship and enterprise development. This is a major challenge for the new market economies in the region.

Worldwide, small business is now seen as a crucial component of national development and as a key provider of new jobs, contributor to economic growth and regional development. For countries in transition to market economies, the growth of small business is vital. Restructuring existing industry is important, but equally important is the need to maximise the growth of new business. The Baltic Forum for Entrepreneurship and Enterprise Development (Baltic FEED) was established with that central aim in mind. The Baltic FEED was set up under the aegis of the Baltic Regional Programme of the OECD's Centre for Co-operation with Non-Members (CCNM), which manages the OECD activities in the region.

The Baltic FEED provides a unique forum for OECD Member countries, Baltic states and adjacent regions of the Russian Federation, international organisations and private sector representatives to share knowledge and experience on small business policy. The 'best practices' in SME policy development, presented in these Policy Guidelines and Recommendations, are distilled from the rich and diverse practical experience across the region and within OECD Member countries, in devising and implementing such policy. They have also benefited from the work of other FEED programmes.

The Baltic FEED is founded on the premise that successful policy development cannot be copied, nor provided unfiltered by other countries or organisations. There are many lessons to be learned, many ideas to be gleaned and adapted from OECD Member countries, but experience shows -- and this is equally applicable to all OECD Member countries -- that there is no single country model that can be adopted. Across OECD Member countries, there are many common aspects to enterprise policy, but the details of their approaches vary. National cultures shape national institutions and influence economic values. Successful policies in enterprise promotion and enterprise development derive from well-managed economies, which respond imaginatively and continually to the specific problems they face. Countries that embrace the global, national and local dimensions of policy are best positioned to succeed in stimulating enterprise.

The continuing FEED process has three key elements:

- The process of sharing experience and reviewing opportunities and obstacles to entrepreneurship. This process has been underway through the case studies and expert presentations from the region;
- The distillation of the views and assessments by the delegates which are presented in these Policy Guidelines and Recommendations; and, most challenging,
- The implementation of the many Recommendations.

The OECD wishes to express its appreciation for the excellent co-operation by OECD Member countries, the governments of the Baltic region, the international organisations which participated, and the many representatives of the private sector and social partners who gave their time and expertise to the FEED process. We look forward to the dissemination of these Policy Guidelines and Recommendations and the continuing FEED process in monitoring their implementation.

Eric Burgeat
Director
OECD Centre for Co-operation with Non-Members

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INTRODUCTION TO THE POLICY GUIDELINES AND RECOMMENDATIONS

1. Introduction

The OECD has consistently pointed to entrepreneurship as a crucial element in creating vibrant market economies. Entrepreneurs -- people who start businesses and make them grow -- are essential agents of change in the process of transition from a centrally planned to a market economy. They are the catalysts of growth, marrying capital, innovation and skilled people.

OECD has focused its work in this area in recent years on developing specific programmes for countries of the former Soviet Union and countries in transition to market economy. The OECD works closely with countries in these regions on producing policy guidelines and recommendations for entrepreneurship and enterprise development.

To date, policy guidelines and recommendations for Transition Economies* (see references, page 73) have been published. OECD is also working on regional FEED policy guidelines and recommendations for specific regions, such as Russian Federation and South East Europe, which will be published in due course.

The Baltic FEED was launched by the OECD as a part of the Baltic Regional Programme. The overall objective of the Regional Programme is to provide a vital contribution to sustainable economic development and to the better integration of the Baltic countries into the global market economy. The Baltic FEED, based on wide participation from the Baltic Rim region and a continuing process of policy discussion, was designed to address this issue.

The Baltic FEED covers Estonia, Latvia, Lithuania, and Russian Federation regions of St. Petersburg and Kaliningrad, and has been developed in dialogue between these countries and the OECD Member countries in the Baltic Rim. This region shares the common coastline of the Baltic Sea, and has strong cultural, historic, economic and trade linkages. For these reasons, OECD considers that these three Baltic countries and the two Russian Federation regions form an appropriate region for a separate FEED programme.

The Baltic FEED has held two working party meetings: in Helsinki, Finland (November 11 - 13, 1998) and in Jönköping, Sweden (March 30 - April 1, 1999) and an Annual Meeting in Riga, Latvia, September 28 - 30, 1999. A subsequent meeting of the FEED Steering Group was held in Jönköping (17th January, 2000). The purpose of these meetings was to allow Ministers, public officials, small and medium-sized enterprise (SME) experts, and private sector representatives from the participating countries, representatives from the OECD Member countries and international organisations to share experiences on enterprise promotion and development. The meetings were hosted by the governments of Finland, Sweden (in co-operation with the Jönköping International Business School) and Latvia respectively. The discussions covered diagnoses of the problems for entrepreneurs and SMEs in the transition countries based on case studies and practical experience from the region, and sought to reach common understanding and guidelines on two main questions:

- How to develop and implement better enterprise policies and programmes
- What constituted 'best practice' in undertaking that task.

OECD Member countries participating in the Baltic FEED are: Denmark, Finland, Germany, the Netherlands, Norway, Poland, Sweden, United Kingdom and the United States. Moreover, a number of

* Albania, Armenia, Azerbaijan, Belarus, Bulgaria, Georgia, Kazakhstan, Kyrgyz Republic, Moldova, Mongolia, Romania, Russian Federation, Slovakia, Slovenia, Ukraine and Uzbekistan

international organisations such as the European Union, the EBRD and USAID as well as chambers of commerce and industry representative organisations played a central role in the work of the Baltic FEED.

Six topics had been identified within the preparatory process of the Baltic FEED programme as crucial and were addressed by delegates:

Institutional Framework for Entrepreneurship

- I. Institutionalisation of SME Policy and SME Representation
- II. Regulatory Framework and the Informal Economy
- III. Tax Policy for SMEs

Support Services and Financial Instruments for Entrepreneurship

- IV. Financial Instruments for Start-ups and SMEs
- V. Advisory Services for SMEs
- VI. Regional and Local Enterprise Promotion

2. Formulation of Policy Guidelines

The case studies and presentations in the FEED meetings provided pertinent region-specific source material for discussion, and formed the basis from which guidelines and policy recommendations on how to better develop entrepreneurship in the Baltic countries were derived. The guidelines, therefore, are founded on the Baltic region delegates' extensive experience with their grass-roots knowledge of the local conditions prevailing in the Baltic countries and the two participating northern Russian Federation Regions. In addition, the guidelines benefit from the wealth of know-how shared by other expert FEED delegates and accumulated from the OECD Member country delegates and committee work within the OECD. The Policy Guidelines and recommendations were amended and approved by the FEED Annual Meeting held in September 1999 in Riga and subsequently reviewed again by the FEED Steering Group meeting in January 2000 held in Jönköping.

3. Policy-making in a Complex and Fast-changing Environment

Baltic FEED delegates stressed the profound impact that the rapidly changing global and regional environment has had on their work. Entrepreneurship and small business development policies need to react to changing reality by a constant adaptation of strategies and tools. It is policy-making with shifting business circumstances and moving targets. A critical task for the future work of the Baltic FEED will be to monitor the implementation of these guidelines and to formulate amendments where necessary. This in turn demands a process of continuous review and innovative action. All participants agreed that the scope of representation and ongoing character of the FEED, in line with the long-term challenge of transition, provided a unique forum for policy discussion and the instigation of innovative action.

4. Format of Guidelines

Each of the six themes has an introduction outlining a short summary of the main content of discussion at the Working Group meetings. This is then followed by best-practice recommendations proposed by the FEED delegates. Interspersed through the guidelines are summary case examples or comments by delegates that are included to illustrate and explain the recommendations.

A summary of the main headings of the policy guidelines and recommendations is provided on the following eight pages.

**BALTIC FORUM FOR ENTREPRENEURSHIP AND
ENTERPRISE DEVELOPMENT
(BALTIC FEED)**

**SUMMARY OF THE POLICY GUIDELINES
AND RECOMMENDATIONS**

<p style="text-align: center;">I. POLICY GUIDELINES AND RECOMMENDATIONS ON INSTITUTIONALISATION OF SME POLICY AND SME REPRESENTATION</p>

- 1. State and publicly present the policies and implementation strategies, which encourage entrepreneurship and enterprise development, and ensure that they are seen as a central aim of national development policies.**
- 2. Specify policy priorities for the SME sector and ensure that performance in achieving these is monitored in an open and transparent manner.**
- 3. Undertake initiatives that build a positive image of entrepreneurship across society and instigate and encourage actions to improve attitudes to new enterprise.**
- 4. Designate institutional responsibility for SME policy at national, regional and local levels, and ensure clarity in roles in order to avoid duplication or overlapping activities.**
- 5. Assign the proper legal responsibility and adequate resources to regional and local government in order to promote and develop SMEs.**
- 6. Spell out the aims and reasons for intervention by government and state agencies in SME policy and development programmes, as well as the directions on how support should be provided and delivered to the SME sector.**
- 7. Establish regular dialogue with SME representatives and seek to develop joint initiatives that will build public/private partnership in supporting them.**
- 8. Put in place action plans and support programmes to address the business development needs expressed by SMEs, and assist them in preparing for accession to the European Union, with its increased competition and opportunities in global markets.**
- 9. Monitor regularly the structure and performance of all aspects of the SME sector, and recognise the need to adapt policy and government programmes to changing circumstances.**
- 10. Provide training and guidance on customer service to personnel in ministries and agencies dealing with SMEs.**

II. POLICY GUIDELINES AND RECOMMENDATIONS ON REGULATORY FRAMEWORK AND THE INFORMAL ECONOMY

- 1. Take action to improve the legal and regulatory environment for SMEs in the key areas where the State has direct responsibility.**
- 2. Improve small business registration, licensing and all state administrative procedures where such procedures are identified as unduly bureaucratic and as obstacles to entrepreneurship.**
- 3. Provide SME representatives with an opportunity to express their views well in advance on relevant draft legislation and regulations.**
- 4. Solicit feedback on a regular basis from SMEs about regulatory and other issues that hinder business development.**
- 5. Seek a change of attitudes by the bureaucracy in dealing with SMEs through specific actions, such as:**
 - **demonstrated high standards at government level**
 - **training of public officials on customer service, and**
 - **establishing codes of good practice expected from officials.**
- 6. Distinguish between broad segments of the informal economy (ranging from businesses in breach of minor misdemeanours to businesses involved in serious criminal offences) when designing policy measures to address the SME sector.**
- 7. Establish a comprehensive and continuing programme to deal with all forms of corruption, especially, in its impact on SMEs.**
- 8. Use international conventions and established networks on bribery, money laundering and anti-corruption in devising policy and implementing action on these issues.**

III. POLICY GUIDELINES AND RECOMMENDATIONS ON TAX POLICY FOR SMEs

- 1. Recognise the crucial role that tax policy plays in influencing and shaping the growth environment for SMEs.**
- 2. Design tax policies with the twin objectives of increasing tax revenues and promoting the emergence and growth of enterprise.**
- 3. Create a clear definition of SMEs for tax and other purposes.**
- 4. Reduce the number and frequency of changes in the tax system.**
- 5. Simplify the rules applied to reduce the compliance burden for SMEs.**
- 6. Ensure the tax laws and rules are transparent and easily accessible by the SMEs.**
- 7. Take practical steps to develop administrative rules to achieve a simple and transparent tax regime for SMEs.**
- 8. Communicate regularly with the SME sector in the development and implementation of tax rules.**
- 9. Encourage the SME sector to present its viewpoint on tax policies and facilitate its regular participation in the government's consultative process on tax legislation.**
- 10. Review tax incentives to ensure each incentive is cost-effective, fair, and properly targeted.**
- 11. Consider special measures to support micro and small enterprises where necessary and the possible use of presumptive taxation (tax base inferred from simple indicators) for the smallest businesses.**
- 12. Develop comprehensive training for tax policy-makers and administrators to prepare them to take a constructive attitude to SMEs, and to equip them to advise businesses on the tax rules and interpretation of such rules.**
- 13. Develop a system to monitor the implementation of recommendations.**

IV. POLICY GUIDELINES AND RECOMMENDATIONS ON FINANCIAL INSTRUMENTS FOR START-UPS AND SMEs

- 1. Seek to strengthen the banking and financial system, and improve the availability of funding for SMEs.**
- 2. Provide selected financial services through public policies where the private sector fails to meet the needs of SMEs.**
- 3. Put priority on measures that will improve access to finance by SMEs and encourage the provision of a broad range of financial instruments, for example:**
 - **leasing**
 - **loan guarantees for fixed asset investment and working capital**
 - **venture capital (including seed capital)**
 - **factoring.**
- 4. Develop loan guarantee schemes and institutions to improve the access to finance, and encourage commercial banks to provide loans to selected SMEs.**
- 5. Seek to foster new attitudes to SMEs amongst banks and other credit institutions, and link this approach with the provision of new funding mechanisms.**
- 6. Ensure that good business practice and systems are followed when disbursing public funds to support SMEs.**
- 7. Provide training and advice for entrepreneurs and staff in SMEs in dealing with financial institutions and loan applications.**
- 8. Ensure that access to finance is improved at the regional and local level, and that SME development policy addresses this issue.**

V. POLICY GUIDELINES AND RECOMMENDATIONS ON ADVISORY SERVICES FOR SMEs

- 1. Identify and review regularly the type of services that small businesses need and build and adapt SME policy on business advisory services accordingly.**
- 2. Intervene only where market gaps exist in the provision of business advisory services.**
- 3. Specify in SME development policy the aims and reasons for government intervention in filling these market gaps.**
- 4. Involve the private sector, as early as possible, in the provision of business advisory services with the objective that in the long run the private sector should become the prime supplier of business advisory services.**
- 5. Use good commercial practices and procedures in managing and operating business advisory programmes and institutions.**
- 6. Aim for sustainability in the design and organisational structure of business advisory service programmes.**
- 7. Seek to diversify funding sources that will contribute to the continuity and enhancement of the programmes.**
- 8. Put priority on the selection, training and ongoing supervision of staff delivering business advisory services.**
- 9. Ensure that adequate budget resources are provided for the selection and training work.**
- 10. Recognise that the promotion of business advisory services is another important form of human capacity building, which is crucial for successful long-term development of the whole economy.**

VI. POLICY GUIDELINES AND RECOMMENDATIONS ON REGIONAL AND LOCAL ENTERPRISE PROMOTION

- 1. Formulate and implement a coherent regional and local development strategy.**
- 2. Research and assess the specific regional and local environment in advance in order to inform and guide the preparation of regional policy.**
- 3. Undertake measures to promote the entrepreneurial climate at the local level.**
- 4. Promote capacity building of regional and local institutions.**
- 5. Facilitate and support the emergence of financial institutions at the local level.**
- 6. Maximise the role that business incubators can play in the promotion of local entrepreneurship and in assisting start-up ventures.**
- 7. Evaluate carefully the full costs and benefits of any proposals to use free economic zones.**
- 8. Promote appropriate use of evaluation methods for local entrepreneurship promotion projects.**

INSTITUTIONAL FRAMEWORK FOR ENTREPRENEURSHIP

I. INSTITUTIONALISATION OF SME POLICY AND SME REPRESENTATION

1. Overview

In introducing the discussion on this subject, the delegates at the Working Party I meeting. Held in Helsinki in November 1998 and the Annual Meeting in Riga in September 1999 stated that these guidelines should be seen as an ‘umbrella’ for all the Baltic FEED policy guidelines and recommendations.

They encompass the wider framework of policies and institutions that support enterprise development, but also refer to the overall environment needed to stimulate and foster entrepreneurship. In this context, the FEED delegates stated that there were key principles and qualifications that should be established:

- All guidelines should emerge from and be founded on the **needs of entrepreneurs**
- The SME sector is not a single homogenous sector. It is made up of **many diverse sub-sectors with different and continually changing needs**.

Small business policy and support programmes need to be flexible and responsive to such needs. OECD studies¹ have shown that entrepreneurship derives from:

- Conducive framework conditions
- Well-designed government programmes that facilitate enterprise
- Supportive cultural attitudes.

FEED Delegates endorsed the validity of these basic requirements through case studies and research papers that were presented. These outlined numerous obstacles and impediments to entrepreneurship and enterprise development in the Baltic region. For example, the need to improve the legal environment and reduce bureaucratic constraints, high taxes and non-transparent procedures, the lack of production and marketing skills, access to development capital, and many initiatives to support SMEs that are often not co-ordinated.

2. What is meant by Institutionalising of SME Policy?

In summary, the key elements were seen to be:

2.1 Coherent Policy and Institutional Framework

- A coherent and focused small business development policy that states clearly the vision of the sector and why and how SMEs will be supported
- Policies and plans to identify and remove obstacles to entrepreneurship
- Clear institutional responsibility and roles within government and regional structures for small business policy, and ensuring that there is understanding of these roles in implementing policies
- Mechanisms to assess the environment for business and to measure the impact of different policies and programmes
- Attention being given to formalising and managing the process and structures, as well as the objectives.

¹ *Fostering Entrepreneurship*, OECD (1998), Paris.

2.2 Policies and programmes founded on good communication and feedback from SMEs

- Effective inputs from and communication with small business sector representatives on policy formulation, implementation programmes and regular evaluation.

2.3 Awareness and understanding across the society of the importance of enterprise

- Broad consensus on the role and importance of SMEs in the national and regional industrial development policy
- Positive attitudes across society that encourage and value entrepreneurship, and ongoing initiatives to build and foster these attitudes.

3. Small Business Promotion: The Challenge of High Expectations

“There is no standard definition of SMEs that is followed by all countries. However, common criteria are: micro-enterprises, up to 10 people; small enterprises 10-50 people, annual turnover up to EUR 7 million, fixed assets not exceeding EUR 5 million; medium enterprises 50- 250 people, annual turnover up to EUR 40 million, fixed assets not exceeding EUR 27 million.”

“Whereas, in a first report presented in 1992 at the request of the 'Industry' Council held on 28 May 1990, the Commission had already proposed limiting the proliferation of definitions in use at Community level; specifically it favoured the adoption of the following four criteria: number of persons employed, turnover, balance-sheet totals and independence, while proposing thresholds of 50 and 250 employees for small and for medium-sized enterprise respectively.”

'Journal of the European Commission', Commission Recommendation of 3 April 1996 concerning the definition of SMEs.

Expectations for the SME sector are high in the Baltic Countries and the two regions of the Russian Federation. Estonian delegates pointed out that SMEs are the main source of new jobs. In Lithuania, the number of SMEs had increased from 20,000 in 1992 to nearly 50,000 in 1998. In Kaliningrad, this number has increased from about 1,000 in 1990 to more than 6,000 in 1998, but the disruption of traditional economic relations due to the new geopolitical situation poses significant economic and social development challenges. Similar developments have taken place in the other participating countries. Compared to the OECD Member countries, the delegates agreed that entrepreneurship and SMEs in the Baltic region still had considerable development potential. Accession to the EU will present opportunities and challenges for SMEs in the region. Taking full advantage of this potential requires progressive policies and a well-planned approach to improving the business environment.

4. Implementing Action in Addressing Constraints

The policy framework for SME development should be based on a detailed knowledge of the problems and constraints that entrepreneurs are facing. For example, a survey undertaken in Latvia identified key constraints for start-up entrepreneurs as:

- Lack of finance (33 %)
- Taxes and institutional environment (29 %)
- Marketing problems (17 %)
- Lack of adequate premises (9 %)
- Labour (6 %)
- Machinery and technology (4 %)
- Racketeering and organised crime (2 %).

Some of the participating countries and regions have had to face particularly severe constraints for SMEs due to the transition process and separation from traditional markets. To enable the ambitious targets for the small business sector in the Baltic region to be met, it was considered essential that urgent action be taken to implement these guidelines.

POLICY GUIDELINES AND RECOMMENDATIONS ON INSTITUTIONALISATION OF SME POLICY AND SME REPRESENTATION

- 1. State and publicly present the policies and implementation strategies, which encourage entrepreneurship and enterprise development, and ensure that they are seen as a central aim of national development policies.**
- 1.1 Affirm the importance of the SME sector to economic and social development by making specific reference in national development plans and policy reform programmes to the crucial contribution of SME to the economy, and to the goals for entrepreneurship and enterprise development.
- 1.2 Undertake a practical development strategy for SMEs that complements macro policies. Key actions are:
 - 1.2.1 Establish development policy and specific objectives for the SME sector.
 - 1.2.2 Create a positive attitude to entrepreneurship across the whole of society, a central theme of SME policy.
 - 1.2.3 Disseminate the policy widely and publicise the aims and actions planned.
 - 1.2.4 Assign clear institutional responsibility for supporting SME development, and for developing SME policies and strategies.
 - 1.2.5 Intervene only where there are market 'gaps' in the support and services needed by the SMEs.
 - 1.2.6 Address local and regional development of the sector.
 - 1.2.7 Streamline support to the SMEs by requiring consultation and co-ordination between relevant ministries and state agencies dealing with the sector.
 - 1.2.8 Communicate with relevant SME interest groups to elicit their inputs and views on the policies and plans to support the sector.
 - 1.2.9 Collect and maintain good statistics on the sector, and arrange research that will assist in developing policy.
 - 1.2.10 Ensure that implementation of policies is monitored and measured.

Enterprise policy is not just a set of programmes...It is a central part of overall economic and national development policy...It needs a body with clear responsibilities to have the proper impact...It needs commitment of people and budget and strategies to maintain and ensure the continuity of the support institutions and programmes...

These are fundamental issues if the vision for growth of SME is to be translated into reality...The attitude of government is more commanding than supporting, this needs to change...

More than 50% of businessmen are not informed of SME policy and support...More attention to the impediments to enterprise is needed and urgent action should be taken to address this...accession to the EU can give a major boost to SMEs in the three Baltic states...there is still much progress to be made in the pre-accession phase.

2. Specify policy priorities for the SME sector and ensure that performance in achieving these is monitored in an open and transparent manner.

- 2.1 Seek widespread awareness and agreement on the policy priorities and indicators of progress desired at national, regional and sectoral levels, so that performance can be properly measured.
- 2.2 Ensure that the institutional responsibilities for supporting the achievement of these progress indicators are stated.
- 2.3 Make the identification and removal of obstacles to SMEs the priority area for action when formulating policies and support programmes.
- 2.4 Seek stability in rules and regulations applying to the sector and continuity as regards the institutions dealing with the development of SMEs.
- 2.5 Make the co-ordination of interaction between the providers of SME support a central objective of policy.

3. Undertake initiatives that build a positive image of entrepreneurship across society and instigate and encourage actions to improve attitudes to new enterprise.

- 3.1 SME policy should provide for practical initiatives that will foster and promote entrepreneurship.
- 3.2 Ensure that SME representative organisations and SMEs are seen to be supported by relevant state organisations by undertaking joint activities.

Examples of joint activities cited by FEED delegates are:

- **Award schemes for entrepreneurs**
- **Shared sponsorship of exhibitions/seminars, etc.**
- **Joint studies or programmes to announce study results and propose new initiatives**
- **Participation at industry/state fora on policy discussions by SMEs.**

- 3.3 Initiate new enterprise studies and project preparation at school and university levels, and support the SMEs in accessing research work and technical expertise in the third level institutions.
- 3.4 Encourage universities to include entrepreneurship in their curricula, and to develop structures to involve SMEs in capitalising on the new product knowledge and technological expertise that exists in third level institutions.
- 3.5 Introduce, where necessary, special schemes to encourage new enterprise by groups that may traditionally not have had a good record of establishing new businesses, e.g. women's groups, minority groups, people from under-developed regional locations, young people and academics.
- 3.6 Gather statistics about successful new enterprises and the people who built them, and distribute case study material.

Creating a positive image and attitude to SMEs across society

“Jönköping in Sweden (where the Working Party II met in 1999 and Steering Group in 2000) is an example of a truly entrepreneurial region. Over 2,000 companies have been established by local residents and many have become significant suppliers of quality products to world markets. Successful local business people have become venture capital investors in many new businesses. At FEED meetings, delegates explained that it is seen as an honour to be a businessperson in the area. This attitude and culture, developed over many decades, has underpinned enormous growth in new enterprise and created a network of businesses that share business and co-operate with each other. It has stimulated new start-ups -- in 1998, 38 new companies were started by students, and local colleges have over 500 agreements with companies to provide industry experience.

The infrastructure for entrepreneurship in the region and throughout Sweden is enhanced by the Jönköping International Business School (JIBS). In 1993, the Swedish parliament accepted the proposal to establish a new business school in the city. Its vision was to be “a pioneering, globally renowned business school with genuine international activities. JIBS will become Europe’s leading education and research centre for entrepreneurship and renewal in industry and commerce”.

It is a school that caters for tomorrow’s needs, geared to satisfy the requirements of students, companies and society at large on advanced education and research. It is the strong focus on entrepreneurship and SMEs that separates JIBS from other, more traditional business schools. The School has extensive international activities, in-demand graduate study programmes, a well-developed working partnership with industry and commerce, growing doctoral research studies and advanced research activities, which are now gaining increasing respect over the world. A central pillar of the research is to find answers to what entrepreneurship is, and how it can be developed in different types of organisations and public sector activities. Internationalisation is one of the cornerstones of JIBS activities and it conducts a working partnership with over 125 universities around the world. To underpin its work it has established a new Information Centre for Entrepreneurship, which is the centrepiece of a well-equipped university library. The centre will be the largest and most comprehensive of its kind, and will be of major importance to the future development of the school.

The example of Jönköping and JIBS demonstrates how a positive attitude to entrepreneurship has been developed, and how it is seen as essential to have such a culture pervade the wider society. More importantly, it provides a very tangible example of the type of creative and wide-impact approach needed to build and foster entrepreneurship and enterprise development.”

Dr. Charlie Karlsson, Jönköping International Business School, Sweden

- 4. Designate institutional responsibility for SME policy at national, regional and local levels, and ensure clarity in roles in order to avoid duplication or overlapping activities.**
- 4.1 Establish clear roles and responsibilities in the institutional structures, and provide the essential legal mandate and resources (people and money) to the relevant institutions.

- 4.2 Review the benefits of establishing an agency or agencies of government, which can operate independently from the more conservative and bureaucratic procedures of Ministries, and that can:
- Implement support programmes in an effective manner
 - Analyse and formulate policy for approval, co-ordinate action, and focus efforts
 - Facilitate the learning process and interaction between government and the private sector.

Legislation affecting SMEs

“As mentioned above, there is neither a formal/legal definition of an SME, nor any legal act specifically targeting such businesses. There is also no official SME policy document, except a chapter in the National Programme for Integration with the EU, indicating the main areas of public support to SME development. This does not mean, however, that Estonian SMEs are living in a hostile environment -- on the contrary, the limited intervention and regulation in the SME sector might be one of the main results for its growth and success. This approach, however, yields positive results only up to a certain limit. When it comes to such issues as improved access to capital, international competitiveness, regional development, fighting unemployment, etc., the solutions are not produced by self-regulatory market forces alone, no matter how liberal an economic system a country has. In the past year or so, especially since the start of accession negotiations with the EU, the Estonian Government has started to recognise the importance of the SME sector for economic and social development, and the need for a well-structured SME policy.”

‘The State of Small Business in Estonia, PHARE Support to SME Development in Estonia, Report 1998’ (p. 23)

- 4.3 Consider the use of an inter-departmental group (including the agency) to review, co-ordinate and harmonise SME policy activities, as well as sharing views on policies that may have an impact upon SMEs.
- 5. Assign the proper legal responsibility and adequate resources to regional and local government in order to promote and develop SMEs.**
- 5.1 Provide local and regional governments with the mandate and resources to create different strategies and programmes in response to different local needs.
- 5.2 Stimulate the development of SMEs in disadvantaged regions or amongst minority and ethnic groups in order to assist social cohesion and regional development.
- 5.3 Empower local organisations to develop local partnerships and fund-raising for SME development.
- 5.4 Improve the policy formulation capabilities of local and regional authorities, and involve them in development programmes available to central state bodies.
- 6. Spell out the aims and reasons for intervention by government and state agencies in SME policy and development programmes, as well as the directions on how support should be provided and delivered to the SME sector.**
- 6.1 Establish intervention and sustainability criteria for policy initiatives.
- 6.1.1 Intervene only where there are market deficiencies and an identified need for public sector action.
- 6.1.2 Specify the objectives and criteria for intervention, for example, what forms of subsidy, expected outcomes, and performance monitoring and measurement.

- 6.1.3 Ensure clarity and common understanding on the definition of SMEs for the purposes of such policies i.e. which groups of businesses are targeted.
- 6.2 Agree guidelines for government departments/agencies on when to intervene, and to what degree.
- 6.3 Use established policy directives to co-ordinate external offers of assistance for SME development.
- 7. Establish regular dialogue with SME representatives and seek to develop joint initiatives that will build public/private partnership in supporting them.**
- 7.1 Create a regular dialogue between SME organisations and public bodies on SME policy in order to:
 - Ensure the practical advice and guidance of SME representatives on policies and programmes
 - Gain mutual understanding of the goals for SMEs and the needs of such businesses
 - Demonstrate the importance of SMEs to all sectors of society.
- 7.2 Ensure early participation of SME representative organisations in the formulation of policies.
 - 7.2.1 Establish good consultative procedures and communication between government departments and relevant pressure groups.
 - Use separate sub-groups on issues such as taxation, labour and transport in order to get expert feedback
 - Ensure that dialogue takes place at national, sectoral and regional levels
 - Involve politicians in the dialogue to assist in gaining a better understanding of the issues entrepreneurs are facing, and to obtain their support.
 - 7.2.2 Facilitate early consultation on proposed legislation affecting the sector -- this will lead to more effective policy and implementation in the long run. In many cases, consultations with the sector do not exist, or allow only for post-factum comments on policy.
 - 7.2.3 Recognise that such consultation can assist in instigating essential legislation, and in acting as a barrier to frequent changes in policy and institutional structures.
- 7.3 Establish transparent criteria to select and involve relevant business and trade associations in the provision of inputs to small and medium-sized policy, and advise on how new initiatives and policies should be best developed. Such criteria might include the number of members, the self-supporting structure of the organisations, the expertise and ability to contribute to such issues, and provide for rotation periods in their participation on policy consultative groups.
- 7.4 Establish public and private partnerships between associations of entrepreneurs, chambers of commerce, industry and trade associations, local government, educational institutions, consultancy groups, etc.

8. Put in place action plans and support programmes to address the business development needs expressed by SMEs, and assist them in preparing for accession to the European Union, with its increased competition and opportunities in global markets.

- 8.1 Ensure policies and support programmes that meet company needs are developed, and prepare them for this new environment.

“Today, most of the SME support programmes are still working along the strategies defined by their donor-founders, which do not necessarily reflect the current needs of SME sector development. It seems to be high time to move from quantitative institution-building to a qualitative one, connecting all the existing support programmes and organisations to a single network and improving the effectiveness of public- and donor-funding, and on the other hand it would create an integrated and multi-faceted enterprise support system, which would be a big step forward in developing SME policies in Estonia”

‘The State of Small Business in Estonia, PHARE Support to SME Development in Estonia, Report 1998’ (p. 27)

- 8.2 Disseminate information to small businesses on a range of key issues relating to competitiveness, export development, world class manufacturing, quality systems, acquisition and application of technology, new technologies such as Ecommerce, etc. and seek to develop support programmes that will help SMEs deal with the changing business environment.

- 8.3 Give more attention to the future needs of many SMEs by assisting them with support for innovation (new product or process development) and greater value added to products.

9. Monitor regularly the structure and performance of all aspects of the SME sector, and recognise the need to adapt policy and government programmes to changing circumstances.

- 9.1 Establish a comprehensive statistical database on SMEs.

- 9.2 Undertake, or instigate, research and information flow on the SME sector needs:

9.2.1 Use studies by public and private research institutes.

9.2.2 Conduct regular surveys, needs assessments, pilot testing of individual policy initiatives.

9.2.3 Seek feedback on the impact of particular policies on SMEs.

- 9.3 Monitor the targeting, results and cost-effectiveness of policies -- the collection and analysis of performance data is crucial for policy-making and evaluation.

- 9.4 Establish this work as a core responsibility of the ministry or agency with designated responsibility for the development of the SME sector.

- 9.5 Adapt policies and programmes to the constantly changing conditions and requirements of the dynamic SME sector.

10. Provide training and guidance on customer service to personnel in ministries and agencies dealing with SMEs.

- 10.1 Provide training that will enable public officials to understand better the SME development policy, and the role and potential contribution of SMEs.
- 10.2 Consider the use of practical techniques and case studies dealing with entrepreneurs, when providing training. In some countries, such training has been found to be very effective.
- 10.3 Consider the development of a manual for public bodies on how to deal with entrepreneurs, which would also specify the standards of service required.

INSTITUTIONAL FRAMEWORK FOR ENTREPRENEURSHIP

II. REGULATORY FRAMEWORK AND THE INFORMAL ECONOMY

1. Overview

The subject of “Regulatory Framework and the Informal Economy” was considered at the Working Party I meeting held in Helsinki in November 1998. The over-riding importance of removing constraints and obstacles to business formation and enterprise development was endorsed by all delegates. On the one hand, a picture of excessive laws and regulations was painted while, on the other hand, there is an absence of adequate laws or proper implementation of laws that influence SMEs in many transition countries. This can have a greater effect on SMEs in the end than the specialised support services often provided to help small businesses. This is particularly valid for those countries where the regulatory framework is under-developed. Delegates from Kaliningrad and St. Petersburg regions pointed out the pressing need for policy action in the Russian Federation.

The main themes emerging from FEED meetings were:

- The need to change attitudes to entrepreneurs and to change culture that is frequently suspicious of and antagonistic to SMEs. Changing the general climate for business was seen as critical and a long-term process -- often this needs to start at the school level, if eventual and real change is to be achieved.
- The desirability of instilling a service culture in state organisations dealing with business.
- More open discussion on new laws and regulations, with better public access to draft instruments.
- The importance of industry representative organisations, chambers, etc., combining, and thereby strengthening their voices in presenting their views and assessment of draft or existing laws and regulations to policy-makers.
- Putting focus not just on the introduction of laws and regulations, but on implementing them. This was frequently seen as the main problem for many SMEs.

Considerable progress in creating legislation and institutions designed to lower the bureaucratic barriers for SMEs was reported by FEED delegates. There was widespread agreement that there is substantial further work that needs to be undertaken in this area by transition countries. Market economies, by definition, have a necessary minimum of state regulation. Numerous surveys and OECD research and experience have shown that removing needless laws and regulations, administrative barriers and other constraints is deemed to be a priority for entrepreneurs. The challenge is therefore not just simply to cut down on unnecessary regulation, laws and administrative procedures for small businesses but equally important, to improve their overall quality and operation. Such action can have a powerful impact on stimulating and promoting new enterprise in transition economies.

2. Simplifying Laws and Regulations

Business registration procedures are a good example of an administrative burden, which can often be improved or at least alleviated by appropriate policy action. The Lithuanian delegates described cumbersome regulations on registration procedures, which have contributed to an environment where about 35 % of registered enterprises have terminated their activities or are not pursuing their business proposals. The government is seeking to simplify the registration procedure.

Estonia has introduced a new procedure to ensure that the potential negative economic impact of laws and regulations is already made transparent within the process of policy formulation in the Parliament. The

Board of the Estonian Parliament has agreed that each draft bill submitted to the Parliament needs to include an explanatory note. This note should explain the potential economic and social consequences of the bill and, in particular, its impact on SMEs. Experience in practice has shown that very often these notes are not drafted well or that there is not sufficient interest shown in the analysis of the economic impacts of new laws. The FEED Delegates therefore agreed that, generally, there was critical attention to be paid and work still to be done in this area in the Baltic region.

Company registration, consumer protection, labour regulation, environmental protection, etc., are all essential legal and regulatory aspects of any market economy, but there are often many unnecessary barriers and unduly bureaucratic procedures associated with such areas. SMEs are usually less able to present their needs to government and lobby them as effectively as larger businesses. They are rarely consulted at the design stage of new policies and reforms. These factors need to be recognised and addressed by policy-makers in developing small business policy.

3. Taking a Constructive Approach to the Informal Economy

Informal economy businesses deprive governments of tax resources. Defective laws and procedures can encourage the shadow economy by forcing some entrepreneurs to avoid proper legal procedures and use bribes or fines to deal with the consequences that arise. This is unsatisfactory in the long run for both governments and entrepreneurs.

Surveys undertaken, for example in Lithuania, have revealed that the informal economy accounts for a considerable share in sectors such as construction and trade. The main reasons for this tendency are stated as follows:

- unemployment and low average salaries
- high taxes
- burdensome legislation
- low level of business ethics.

It is important to create a better environment for small business and to remove the obstacles to legal business formation, regulation and the general conduct of business in the formal economy.

4. Undertaking Measures to Deal with Corruption

There was a strong consensus on the need for comprehensive and continuous action on a number of fronts to deal with corruption. There is already wide analysis available on many aspects of corruption and what should be done to combat it. FEED Delegates strongly emphasised the urgent need for action in implementing anti-corruption measures, and in ensuring that regular review and action is taken in a systematic and continuing programme.

In the recent Council of Baltic Sea States meeting in Bergen, Norway, 7 - 8 February 2000, among other issues, the establishment of a Baltic Integrity Programme was discussed. The Programme would deal with fact-finding and evaluation of the legal and institutional framework for fighting corruption, enforcement procedures and organisation of enforcement agencies, arrangements for business integrity, and developing anti-corruption culture in the political system and civil society.

POLICY GUIDELINES AND RECOMMENDATIONS ON REGULATORY FRAMEWORK AND THE INFORMAL ECONOMY

- 1. Take action to improve the legal and regulatory environment for SMEs in the key areas where the State has direct responsibility.**
- 1.1 Simplify red tape and increase transparency on registration of businesses, licensing, tax inspection procedures, border crossing, and on other administrative procedures that affect the operations of SMEs.
- 1.2 Ensure good public access to information on legislative proposals affecting SMEs.
- 1.3 Have fewer authorities and state bodies dealing with small business -- multiple tax and licensing authorities can create confusion and are often counter-productive for both the state and entrepreneurs.
- 1.4 Require all ministries and state agencies dealing with small business to pay attention to regulation systems, and, ideally, have a regulatory reform plan to reduce regulatory procedures or implement deregulation.
- 1.5 Undertake effective enforcement of anti-trust legislation.
- 1.6 Improve administrative procedures, in particular, secondary regulations/ordinances.
- 1.7 Continually monitor and take action to address new barriers and obstacles that may emerge both in the introduction and in implementation of laws and regulations.
 - 1.7.1 Recognise that rationalising the administrative process is an ongoing process that is not resolved by one reform.
 - 1.7.2 Monitor problems that may arise with the application of the law.
- 1.8 Effective implementation of laws and regulations should be underpinned by judicial and commercial expertise and appropriate penalties for non-compliance.

Rule of Law – insufficiently developed legal structures

“This is the most serious problem facing the region. The inadequate legal structures in all countries in transition are a major obstacle for the development of business. Both domestic and foreign investments are impaired because of the uncertainty of the legal system. All information we have acquired supports this conclusion.

We conclude that the efforts so far have not been sufficient to overcome the difficult problems. Improvements in the legal structures must be a subject of highest priority in all countries in transition and an area for intensified support from the other countries and the European Union.”

‘Memorandum on Conditions for Growth and Development in the Baltic Sea Region’, Baltic Sea Business Summit 98, prepared and facilitated by The Stockholm Chamber of Commerce (p. 6)

2. Improve small business registration, licensing and all state administrative procedures where such procedures are identified as unduly bureaucratic and as obstacles to entrepreneurship.

2.1 Undertake a systematic and professional study to identify and alleviate the major constraints to registration (and licensing where relevant) of new businesses where such procedures are identified as cumbersome -- this type of study can provide a good basis for action to improve systems.

2.2 Reduce needlessly complicated and time-consuming business registration, licensing and administrative procedures relating to business start-ups.

2.2.1 Consider the use of one-stop-shops, facilitating entrepreneurs by reducing the number of offices where they must go to undertake registration or similar procedures.

2.2.2 Enterprise registration should be simplified and, preferably, reduced to the entry of requisite data in a unified register of legal entities. It should be of a notification nature.

2.2.3 In similar fashion, seek to reduce the number of licenses required by SMEs and the time needed for issuing licenses.

2.3 Establish new licensing procedures and standards where necessary, and minimise the list of activities subject to regulation.

2.3.1 Recognise that the absence of clear licensing procedures and uniform licensing standards can lead to uncontrolled expansion of licensing requirements at both national and local levels.

2.3.2 Be alert to the fact that in some cases local trade patent fees have in effect replaced licensing. This type of scenario needs to be countered by new procedures and standards.

2.4 Examine not just the regulations, but also the compliance costs, and ensure that they are not an obstacle to new businesses -- these are often more burdensome for small firms.

3. Provide SME representatives with an opportunity to express their views well in advance on relevant draft legislation and regulations.

3.1 See SMEs and their representative organisations as partners who have the potential to assist in developing policy and encouraging compliance by members. Effective laws and regulations require the active participation of the SME sector.

Transparency in Legislation

Involve experts from the business community already in draft group

Make draft proposal public (allow time!)

- Invite written opinions from different organisations and companies
- Invite to a dialogue on the draft proposal (council, hearing, etc.)

Amend proposal (and submit to Parliament)

Parliament committee should allow opinions to be submitted

Make law (regulation) public in due time before enacted

Presentation by the Stockholm Chamber of Commerce at the Baltic FEED Annual Meeting, September 1999

- 3.2 Involve the business sector in the design stage of new laws and regulations affecting SMEs -- no involvement at this stage will lead to emergence of deficient new laws and procedures.
 - 3.3 Involvement should be open, that is, not restricted to select groups only, and not just in a 'post factum' manner.
 - 3.4 Establish procedures for listening to SMEs concerning the impact of laws and regulations on their businesses, and the setting priorities for action.
 - 3.5 Strengthen SME agencies so that they can contribute to voicing the needs of SMEs and improving the legal and regulatory infrastructure for them.
 - 3.6 Private associations of entrepreneurs, employers' organisations, chambers of commerce, etc. have an important role to play in this process, in creating awareness of difficulties and obstacles presented by legislation and regulations or hostile bureaucracy. Mechanisms should be established by government to gather the views of these bodies at the design stage of regulations.
- 4. Solicit feedback on a regular basis from SMEs about regulatory and other issues that hinder business development.**
- 4.1 Conduct annual surveys of perceived constraints to growth by SMEs as well as periodic surveys on specific issues.
 - 4.2 Information and data received can be valuable to policy-makers and SME associations in developing policy dialogue and action plans to address issues.
 - 4.3 Statistical information can be gathered from company registration data, but surveys can provide qualitative information on opinions, perceptions, problems, etc.
 - 4.4 Encourage and listen to SME research and advocacy groups. These can give insights that may not be evident from general surveys.

Examples of consultation procedures taken by some countries and international organisations.

"This is an issue that was of concern also to EU Member States according to the EU delegate at the FEED meetings. The EU set up a 'Business Environment Simplification Taskforce' (BEST), which looked at attitudes to entrepreneurs, education and training on the subject, and the general environment for entrepreneurs. This taskforce came up with recommendations that were well received. Key issues were the need to change the culture and attitudes to entrepreneurs. Specific recommendations here were the need to include 'entrepreneurship' in school programmes and the reduction of regulation of SMEs. In the USA and Finland, the use of 'Business Test Panels' or 'Enterprise Forums', where groups come together once a month with officials to talk about problems and issues for entrepreneurs, has helped to identify numerous points of action that can help to improve the environment for entrepreneurs and guide the drafting and implementation of laws and regulations affecting SMEs."

Comments on specific consultative actions taken as reported at Baltic FEED meetings, 1999

5. Seek a change of attitudes by the bureaucracy in dealing with SMEs through specific actions, such as:

- **demonstrated high standards at government level**
- **training of public officials on customer service, and**
- **establishing codes of good practice expected from officials.**

5.1 Seek to change the attitudes of civil servants towards small business by providing examples from leading government officials and policy-makers -- an important ingredient in bringing about such a change will be the direct role and leadership played at the highest political and policy-making level.

5.2 Provide more training for all public officials dealing with SMEs.

5.3 Introduce training that will help civil servants to understand better the role of the businessman.

6. Distinguish between broad segments of the informal economy (ranging from businesses in breach of minor misdemeanours to businesses involved in serious criminal offences) when designing policy measures to address the SME sector.

6.1 Recognise that the informal economy is made up of different segments, and there is a need for policy-makers to take account of these when designing policies.

6.2 The three segments described below are not watertight in their definition but for the purposes of developing policy, they provide a useful categorisation to determine different policy approaches and different action strategies, which should be taken with the various segments of the informal economy.

6.2.1 First segment - the informal economy segment where businesses operate generally within the law but may, for example, have not been properly registered at start-up.

6.2.2 Second segment - the 'shadow' or 'grey' segment where the business activity is legal but where there is some non-compliance with the law or regulations and some systematic infringement of the legal system (for example, evasion of tax). Bureaucratic and inefficient administrative pressures within the state system may be forcing such businesses into breaches of law.

6.2.3 Third segment - the 'black' economy segment which is illegal or criminal business and where the promoters do not intend to ever create a legal business.

6.3 Recognise that it is vital to understand what is happening in the various segments of the overall informal economy.

6.3.1 Instigate systematic research and professionally conducted surveys, where necessary, to establish clearly what is going on in each segment of the informal economy. In general, much more effort and resources should be given to this task by transition country policy-makers.

6.3.2 Analyse the wealth of information already available (e.g. through www.nobribes.org) on the subject of corrupt practices, and use it to draw conclusions on policy design, and to initiate action to deal with corruption. There is much useful information readily available.

7. Establish a comprehensive and continuing programme to deal with all forms of corruption, especially, in its impact on SMEs.

- 7.1 Take action to change administrative systems and specific procedures, which may be a significant cause of businesses moving into the informal economy and adopting corrupt practices.
 - 7.1.1 Recognise that this requires political leadership and will to reform rules and institutions and to work with actors in the informal economy to understand key constraints which promote corruption.
 - 7.1.2 Recognise that it is important not to suppress the entire informal economy, except for the “black” economy segment, but to seek to create the environment where legitimate business people are facilitated to become part of the formal economy.
 - 7.1.3 Remove or change administrative restrictions that are burdensome and time-consuming. Such restrictions force businesses to evade them and use informal sources.
 - 7.1.4 Establish a system to review objectively proposals for new laws and regulations and the impact of these on SMEs before they become formalised.
 - 7.1.5 Consider the use of approval by positive-administrative silence in certain circumstances, i.e. if no decision is given by a certain date it means that automatic approval applies.
- 7.2 Strengthen judicial systems to allow an expeditious and efficient handling of court cases.
 - 7.2.1 Speed up case handling in the judicial system. In some transition countries, cases take too long to go through the legal process.
 - 7.2.2 Institute open and transparent methods of case tracking to see where cases “bottleneck”.
 - 7.2.3 Institute more pre-court practices or legal system substitutes such as arbitration and other out-of-court dispute resolution procedures.
 - 7.2.4 Consider the use of “ombudsman” roles to resolve commercial disagreement.
- 7.3 Use open procedures in public procurement contracts, sale of commodities, dealing in real estate, etc. These systems should be open (e.g. open tendering) and transparent, and based on objective criteria. There should be clear procedures on the bidding method, solicitations for bids, choice of contractor, and the terms of contracts should be non-exclusionary.
- 7.4 Undertake participatory and publicised campaigns of anti-corruption measures (such as Transparency International’s integrity systems, or national plans like in Latvia and Estonia) to deal with corruption both in the public and private sectors.
 - 7.4.1 Involve SME representative organisations in this process -- seek wide and active co-operation with the private sector.
 - 7.4.2 Pursue the general principle of trying to retain and encourage the initiative and enterprise of the informal economy while, at the same time, taking specific action that will facilitate them to become part of the formal economy.

- 7.4.3 Establish internal and integrated audit functions in Ministries and state agencies dealing with businesses, giving them the authority to investigate misdeeds or pass cases to the appropriate authorities. It should be recognised that such audit functions are only as good as the power given to them.
- 7.4.4 Select public officials based on their integrity and provide periodic training on detecting and preventing corrupt practices.
- 7.4.5 Require officials, as part of their employment contract, to work in a law-compliant manner.
- 7.4.6 Establish “whistle-blowing” rules protecting officials and enterprise employees from discriminating or disciplinary action, and where they draw attention to corrupt practices.
- 7.4.7 Legislate that bribes paid domestically and in the course of international business transactions are not tax deductible.

Criminal Activity and Poor Ethics

“Another serious barrier to trade and economic co-operation is criminal activity and poor ethics with respect to public officials as well as companies. The following of honest methods promotes business development because then the success hinges to a large extent upon the efficiency and quality of a company’s own activities. Criminal activity appears in the Baltic Rim area in the form of smuggling and illicit business activities.”

‘Barriers to Economic Co-operation of Baltic Rim Countries’ Discussion Papers No. 55, Report for the Finnish Ministry of Trade and Industry, The Research Institute of the Finnish Economy

8. Use international conventions and established networks on bribery, money laundering and anti-corruption in devising policy and implementing action on these issues.

- 8.1 Be aware of the existence of the ‘OECD Convention on Bribery of Foreign Officials in International Business Transactions’ which provides a useful guide to transition country policy-makers as they develop their policies in this area.
- 8.2 Participate in international networks, for example, the OECD Anti-Corruption Network for Transition Economies dealing with anti-corruption measures which:
 - Share concrete policy change and project data (such as judicial reforms, procurement reform, integrated financial systems, civil service reform, deregulation, etc.), and facilitate anti-corruption programme design and implementation.
 - Share survey data and contact information involving important actors in the reform process, and allow countries to engage in “action learning” with partners to address complex and changing corruption issues.

INSTITUTIONAL FRAMEWORK FOR ENTREPRENEURSHIP

III. TAX POLICY FOR SMEs

1. Overview

At the Working Party I meeting in Helsinki in November 1998, the subsequent Annual Meeting in Riga in September 1999, and the Steering Group meeting in January 2000, the Baltic FEED delegates considered the subject of tax policy for small business. These introductory notes outline the priority issues identified at these meetings.

Three main points were consistently emphasised at the FEED meetings and presented in many case studies:

- There are huge possibilities for SMEs in the Baltic region to develop and their contribution to national development and the transition to market economy are critical
- The tax systems in the region are vital to creating the essential business environment for SMEs and to achieving the opportunities and benefits of a vibrant and growing small business sector
- There was strong endorsement of the policy guidelines and recommendations on tax policy for small business and of the urgent need for action in implementing them.

While there has been progress on tax reform, there are still many aspects of the tax systems and attitudes to entrepreneurs that need to change and improve. An EBRD survey of 7,000 businesses in transition countries revealed that the tax system is perceived by SMEs as one of the main constraints to doing business. Similar surveys, for example in Latvia, show that access to capital and the tax system were cited as the main problems for start-up businesses. SME entrepreneurs were described by a Swedish delegate at the FEED working party meeting as “heroes of the society” and should be seen as such. There is a need for more positive and supportive attitudes to entrepreneurs. Such businesses need to be “pushed up rather than hammered down” in the words of another FEED delegate, and the tax systems have a crucial role here. The challenges facing tax policy-makers in the Baltic Region are illustrated by the following extracts from case studies presented:

“Today Lithuanian SMEs are facing many problems which were highlighted through questionnaire responses and face-to-face interviews...high levels of taxes and social security charges force employers to drive up prices, thereby weakening competitiveness...uncertainty of tax liability makes tax planning difficult...the Municipality and Tax office are not ‘business-friendly’.”

“High tax rates in Latvia are seen as an obstacle to start up businesses. Common tax burden is too heavy...state tax policy does not promote investments...tax administration system forces tax-payers to make extra expenditures besides main tax-pay amounts and sometimes one should pay taxes for transactions that actually did not take place...on the whole, the tax system is estimated by 50% of the SME entrepreneurs not to have changed, but 40% of them think that situation has become worse...the present situation indicates that there exists a great disbelief in the intentions of state institutions to assist and support entrepreneurs. There is no feedback between the government and the entrepreneur as a taxpayer. That factor diminishes their motivation to pay taxes even more.”

Examples of references by FEED delegates from all Baltic region countries at the FEED meetings, 1998/1999

Small businesses are a vital source of new jobs and wealth creation, and can potentially make a major contribution to economic and regional development, as well as to increased tax revenues. In developing

their policy guidelines and recommendations, the Baltic FEED delegates sought to identify the features of a tax system that can stimulate and foster the growth of the small business sector.

2. Establishing Stability and Predictability in the Tax System for SMEs

The most urgent feature required in tax systems and frequently referred to by FEED Delegates was equitable and fair systems, which are not continually changed, so that SMEs can plan for tax liabilities. Stability and continuity will facilitate compliance, as was emphasised repeatedly by FEED delegates. While many small businesses may see taxes as a burden to the development of their businesses, the real hindrance for most is what is often the unknown and unpredictable nature and timing of the level of tax to be paid. This problem arises from complex tax codes and varying interpretations and applications of tax rules. Tax systems should also ideally be simple and transparent. Simplification can reduce the time and effort needed by businesses to administer their tax affairs, and better transparency in tax systems will help to avoid discriminatory interpretation and potentially corrupt administration.

3. Establishing a Uniform Tax System for Business

While asserting that SMEs had special needs, FEED delegates warned against establishing a separate tax regime for such businesses. The first principles of the tax system should be as outlined above -- **fair and equitable tax rates, stability and predictability, simplification and transparency** -- and the ultimate target should be to have a uniform system based on these principles for all businesses. However, small businesses have disadvantages, for example, in economies of scale, access to finance, resources to deal with complex tax administration, and being less organised and able to represent their needs, compared to large companies. This requires that provision be made for constructive dialogue with the SME sector about tax laws, and for adaptations to the tax system to foster and support the growth of the sector. Within the tax system, there were recommendations that clear definitions of SMEs should be established. Tax policy-makers should also recognise that both the tax burden on business entities and individuals that invest in start-up businesses should be commensurate with the risks being taken in developing such businesses.

4. Examining the Use of Tax Incentives

The advantages and disadvantages of using tax incentives to promote SMEs were extensively discussed at FEED meetings. It was noted that all OECD Member countries apply special measures, including tax measures, intended to improve the economic and technological environment for small enterprises, and to facilitate their establishment and growth. Expert delegates at the FEED meetings pointed out that special tax incentives for small businesses had frequently not been cost-effective in achieving their goals. They were often directed at an activity that would have occurred in any event, and they were a major source of complexity in the tax system. They were also subject to significant tax avoidance possibilities. It was recommended that in most cases it may be more appropriate for transition economies to (a) focus primarily on changes which remove impediments to the growth of the small business sector and (b) reduce tax rates, rather than targeting special tax incentives at the sector. Where incentives are being considered, there should be clear statements of impact sought and monitoring of the cost-effectiveness of any such measures.

5. Importance of Implementing the Guidelines

The guidelines presented here are an important framework for governments and policy-makers in developing their tax policies. There was a strong consensus by all FEED delegates that the implementation of these guidelines, which set out key principles and policy guidelines, was crucial to entrepreneurship in the Baltic countries, and future FEED meetings should monitor action and progress on this.

<p style="text-align: center;">POLICY GUIDELINES AND RECOMMENDATIONS ON TAX POLICY FOR SMEs</p>
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1. Recognise the crucial role that tax policy plays in influencing and shaping the growth environment for SMEs.

1.1 SMEs are potentially a dynamic source of employment growth and wealth creation in all transition and emerging market economies. Governments and policy-makers should be conscious that they play a decisive role and have a fundamental responsibility of shaping the environment for such businesses through their policies, in particular, tax policies.

1.2 Improve the business environment for SMEs by using the tax policy in a constructive and conscious manner to:

1.2.1 Create a private enterprise environment that facilitates new businesses to start up.

1.2.2 Encourage existing SMEs to develop and expand.

2. Design tax policies with the twin objectives of increasing tax revenues and promoting the emergence and growth of enterprise.

2.1 Ensure that tax policy reform is founded on principles that clearly express the mutual aims and responsibilities of:

- Compliance by SMEs
- Fair and equitable taxation by government.

2.2 Make it clear that mutual success is the goal, namely, governments will collect more revenue when the SME sector succeeds and grows.

2.3 Develop and inculcate better understanding and more supportive attitudes amongst fiscal policy-makers and administrators to the small and medium-sized sector.

2.4 Seek to create an environment where Governments and tax authorities see SMEs as important contributors to economic progress and growth, creation of jobs and regional development, as well as a major source of tax revenues.

2.5 Policy-makers and SMEs have an obligation to work together and instigate constructive dialogue to achieve their respective goals.

3. Create a clear definition of SMEs for tax and other purposes.

3.1 Establish a definitions of what businesses come under the SME sector and ensure that the definitions encompasses micro, small, and medium-sized enterprises.

3.2 Apply common legal definitions for tax policy and all other policies that deal with small business development.

- 3.3 Recognise that other countries and international organisations may have different definitions based on their circumstances. The definition adopted by transition countries should take into account the need for compatibility with such international definitions and the structure and needs of the indigenous SME sector in the particular transition country.

4. Reduce the number and frequency of changes in the tax system.

- 4.1 Avoid frequent changes to the tax system -- be aware that they are the greatest source of complexity and burden on SMEs.
- 4.2 Recognise that the SME sector generally lacks the financial and human resources needed to master frequently changing tax laws.
- 4.3 Be conscious that tax administrations do not have the time to develop new regulatory guidance, forms and instruction manuals for SMEs each year.
- 4.4 Frequent change will result in more administrative burdens for SMEs and a drop in compliance.

5. Simplify the rules applied to reduce the compliance burden for SMEs.

- 5.1 Simplify the tax rules applying to the SME sector and reduce the compliance burden. Simplicity of tax codes facilitates both tax administration and compliance.

- 5.1.1 Reduce the number of taxes where necessary, examine the full range of taxes applying to SMEs, and eliminate small taxes, which often cost more to collect than they raise in revenue.

At FEED meetings, there was reference to 18 separate taxes applying to SMEs in Lithuania and up to 30 such taxes in Latvia. The general view of expert advisors at FEED meetings was that the more appropriate number should be no more than five taxes.

- 5.1.2 Monitor and benchmark the views of SMEs on the tax burden. If this burden is continually deemed to be an obstacle to enterprise, then instigate a full review with the aim of reducing tax rates and/or eliminating categories of taxes.
- 5.1.3 Recognise that high tax rates and over-complex procedures imposed on small business force enterprises into the shadow economy and may lead to a reduction in the total tax revenue from the small business sector.

“Salary-related taxes, corporate tax and the delay in recuperating VAT are all major problems, which have been identified by entrepreneurs and pointed out in several ways in the survey. Provision for SMEs should be considered especially regarding their contribution to the creation of new jobs: this concerns mainly salary-related taxes. Such provisions would have an important economic and social impact and would likely improve employment even in the poorest areas. Investment-related tax allowances and tax credits on corporate income would essentially increase domestic investments and decrease the need for external (bank) financing. Speeding up and simplifying the procedure of reclaiming VAT would substantially improve the cash flow of SMEs and decrease their working capital requirements. In general, there is a need to reduce and simplify as much as possible all bureaucratic burdens on SMEs”

The State of Small Business in Estonia. PHARE Support to SME Development in Estonia. Report 1998

- 5.1.4 Recognise that the personal tax burden imposed on investors, including SME owners, is also vital for promoting new investment, and therefore an analysis of this should be included in all tax reviews and tax reform programmes.
- 5.1.5 Avoid complex rules and schemes to benefit certain businesses, which may be ineffective and inefficient.
- 5.1.6 Calculate the average time taken by the typical SME in complying with its tax obligations. If this time is excessive or is increasing each year, then reduce the time burden by making procedures more efficient or by reducing the number of taxes.

6. Ensure the tax laws and rules are transparent and easily accessible by the SMEs.

- 6.1 Publish all laws and interpretative guidelines well in advance of application. Facilitate access to them, for example:
 - Circulate short summaries that explain the main highlights to businesses
 - Distribute full versions of laws/rules to tax advisers or to businesses on request
 - Place them on the Internet ensuring regular updates where necessary
 - Encourage discussion with industry associations on questions of interpretation
 - Provide explanatory articles for specialist tax and business magazines.
- 6.2 Distribute all tax forms for free -- for example, the registration form, all tax returns and tax exemption forms. These should be readily available at all tax offices, business centres, business incubators, and government or regional information centres.
- 6.3 Develop and distribute free handbooks that describe tax obligations of those opening or operating SMEs, and encourage business book publishers to produce expert explanatory guides.
- 6.4 Ensure that up-to-date handbooks are available at all times.

“The problems of small and medium enterprises concerning payment of taxes and duties most often are related to lack of information on the methods of tax legislation application elaborated by the State Revenue Service and various instructions. Therefore, it is necessary to develop on the basis of existing advisory units an independent regional service of tax advisors.”

Extract from case study ‘Tax and Subsidies in Latvia’ by Ms. Ilga Preimate, Deputy State Secretary, Ministry of Economy, Latvia, presented at FEED meeting 1998

7. Take practical steps to develop administrative rules to achieve a simple and transparent tax regime for SMEs.

- 7.1 All tax laws should use consistent definitions of assets, liabilities, sales, gross income and net income for tax calculations.
- 7.2 Create a simple, one-page registration form that is applicable for business registration, tax and all other related government purposes.
- 7.3 Adopt less frequent reporting and payment obligations, for example, quarterly rather than monthly.
- 7.4 Provide clear and timely taxpayer assistance. For example, establish telephone help-line or tax offices where tax advice can be obtained easily and free of charge.

- 7.5 Adopt appropriate penalty regimes that distinguish between mistakes and intentional evasion of tax.
- 7.6 Consider exempting micro-enterprises from certain taxes, for example VAT, below a certain threshold.

“Of all the taxes, value added tax places the greatest administrative burden on SMEs and, as a result, many countries have created measures to ease this burden. In the UK and Ireland, there is a threshold below which companies do not need to register for VAT. This removes the need for complex bookkeeping, which in itself would not be productive for the business. Certain sectors e.g., retail, have simplified forms of VAT and this is fairly common in the UK, Germany, France, Netherlands and Denmark.”

Extract from case study ‘Strategic Objectives and Programmes for Entrepreneurship and Business Development in Lithuania’ by Mr. Sergejus Krispinovcius, Head of Regional Development Division, Ministry of Public Administration, Reforms and Local Authorities, Lithuania, presented at FEED meeting 1998

- 7.7 Allow micro-enterprises to use cash accounting rather than accrual accounting.
- 7.8 Micro and small enterprises should be allowed to use simplified accounting procedures, which retain necessary accuracy without being too difficult to administer.
- 8. Communicate regularly with the SME sector in the development and implementation of tax rules.**
 - 8.1 Implement reviews and surveys to obtain feedback from SMEs on the tax system and its application.
 - 8.2 Consult regularly with the SME sector while developing or reviewing tax laws that affect the sector and ensure that the consultation itself is transparent. Consultation should take place before tax laws are enacted.
 - 8.3 Ensure that reform goals and strategies are articulated clearly to the SME sector.
 - 8.4 Prepare information briefs for distribution on possible changes to the rules and provide drafts of laws or White Papers to the SME sector for comments.
 - 8.5 Create a forum of entrepreneurs to give advice on draft tax legislation.
 - 8.5.1 Institute formal mechanisms for regular briefing and consultation with small business representative bodies.
 - 8.5.2 Ensure that relevant interest groups are kept up-to-date with new tax code changes and can give views that will assist in the eventual implementation.

“The process of consultation should not be a loose or casual arrangement. It needs to be made ‘operative’ with good procedures on whom to consult and when consultation should take place. For example, in Latvia there are over 100 business associations representing different segments of the SME sector. This makes it difficult to consult all such groups individually and gather their views on tax policy. To address this issue a Council of Branch Experts has been formed and all proposed changes in tax codes seek to obtain input from this representative group.”

Extract from case study ‘Tax and Subsidies in Latvia’ by Ms. Ilga Preimate, Deputy State Secretary, Ministry of Economy, Latvia presented at FEED meeting 1998

9. Encourage the SME sector to present its viewpoint on tax policies and facilitate its regular participation in the government’s consultative process on tax legislation.

- 9.1 Encourage and support the organisation of the SME sector at a political level to enable it to better interact with the government on relevant policy issues. This will help to achieve better mutual understanding of the aims of tax codes, and the practical inputs to the shaping of codes that are more effective.
- 9.2 Educate SME owners on their tax obligations.
- 9.3 Provide forums for business owners and tax officials to exchange views on a regular basis.

10. Review tax incentives to ensure each incentive is cost-effective, fair, and properly targeted.

- 10.1 Be aware of the OECD and transition countries’ experience with tax incentives, which suggests that they:
 - are often inefficient if not well-targeted
 - may be unfair because they are given only to businesses with profits, while start-ups often have losses in the first years of operation
 - lend themselves to fraud and abuse
 - are hard to remove
 - result in a loss of predictability of tax revenues
 - may result in revenue loss substantially exceeding the amount of new investment.
- 10.2 Evaluate in advance all proposals for tax-based incentives and establish clear objectives, timeframes and results expected.
- 10.3 Improve the effectiveness of existing tax incentives.
 - 10.3.1 Make sure that the intended beneficiaries are the actual beneficiaries. For example, ensure that the small business tax rate does not apply to large businesses, which form separate small businesses to do the work in order to avail themselves of tax incentives.
 - 10.3.2 Make sure that targeted activities are the actual subsidised activities. For example, ensure that specific tax subsidies for agriculture do not benefit industrial processing.
- 10.4 Monitor the effectiveness of each tax incentive by regular surveys or other methods to identify the impact of the incentive and compare the estimated cost of the incentive with its actual cost.

10.5 Ensure that policy-makers understand that tax incentives are equivalent to direct spending programmes in that both result in a loss of budget resources.

10.6 Resist tax incentives targeted only at foreigners because this:

- Hampers the competitiveness of domestic SMEs
- Leads to certain domestic SMEs creating foreign parent companies to take advantage of incentives.

10.7 Consider lower rates for all businesses rather than targeted tax relief.

11. Consider special measures to support micro and small enterprises where necessary and the possible use of presumptive taxation (tax base inferred from simple indicators) for the smallest businesses.

11.1 Examine the introduction of presumptive taxation for domestic small businesses, i.e., the desired base for taxation is not itself measured but is inferred from simple indicators which are more easily measured than the base itself.

11.2 Analyse benefits of presumptive method including:

- Simplification and lower compliance burdens for the businesses and tax administrators
- Less scope for tax evasion if indicators are more difficult to hide than the true tax base
- More tax revenue from each taxpayer if enforced properly.

12. Develop comprehensive training for tax policy-makers and administrators to prepare them to take a constructive attitude to SMEs, and to equip them to advise businesses on the tax rules and interpretation of such rules.

12.1 Ensure that training explains the importance of new enterprise and small business to regional and national development, and the crucial role of tax policy and tax administration in shaping the environment for enterprise and enterprise development.

12.2 Train tax officials on the substance of tax rules and procedures in order to assist SMEs to comply with the rules, and to ensure familiarity and common interpretation across regions.

12.3 Conduct business surveys on how entrepreneurs perceive the tax system and its impact on their business and take into account the results of such surveys when reviewing the tax system.

13. Develop a system to monitor the implementation of recommendations.

13.1 Recognise that the value of these policy guidelines is heavily dependent on the implementation process.

13.2 Ensure that these guidelines are widely distributed and explained to policy-makers, parliamentary groups and those who influence tax policy.

13.3 Implement a process to discuss the guidelines, develop action on how they will be implemented, and monitor progress.

IV. FINANCIAL INSTRUMENTS FOR START-UPS AND SMEs

1. Overview

The lack of finance is one of the core difficulties entrepreneurs are facing when starting and developing their businesses in the OECD Member countries. Due to the specific situation of transition, this difficulty appears to be even more severe in the Baltic countries. According to a report by the International Finance Corporation, the lack of finance is cited as the most important problem faced by SMEs in these countries.

This is the result of a number of factors, among them, the banking system not being competitive or banks often being more attracted by investments in high-yielding state bonds. Similar to the experience in OECD Member countries, the transaction costs of lending small amounts are proportionally higher than those of large amounts, which makes small business lending in the Baltic countries commercially unattractive for most banks. The common problem of high transaction costs is exacerbated as well through a lack of banking staff experienced in risk assessment for small businesses.

Consequently, only a limited number of SMEs can manage to obtain credits from commercial banks. Typically, these are businesses that are able to meet the close scrutiny of the banks which need to maintain a low-risk profile and get a good margin on their own transactions. These businesses are usually a small group of medium to large businesses, which have good predictability of their market, have experienced management with a known track record, and have availability of collateral or guarantees.

2. Alternative Financial Institutions

In order to help those enterprises that have viable business projects but which do not fulfil the requirements of banks, non-traditional (or alternative) funding institutions have emerged in all Baltic countries as well as in Kaliningrad and St. Petersburg regions. The role, the potential and limits of these non-traditional financial institutions, was the main focus of the work of the Baltic FEED Working Party II. Increasing the financial resources available to SMEs through non-traditional funding institutions was noted as one of two major streams of public action -- the other stream being a general improvement of the financial environment.

Non-traditional financial institutions include a wide range of institutions with different objectives and funding resources. What they all have in common is that the project risk profile which they accept is higher than that of traditional banks and the rate of return may not be remunerated at the same market rate as that of commercial banks or investment banks. Examples of non-traditional financial institutions are:

- Public schemes extending credit directly to SMEs
- Credit guarantee agencies
- Credit co-operatives
- Small business equity funds
- Micro-credit schemes.

These are a few examples of a large variety of institutions. Funds come from public sources, often from international or bilateral aid programmes, but also from private sources, for example, business associations. The objectives of these fund providers can be the promotion of SMEs, job creation and regional development. Therefore, their strategy regularly goes beyond pure financial objectives. This allows the extension of financial services to a much broader range of enterprises as compared to a more proven

commercial client base. The discussion at the FEED working group showed that there are a number of requirements and challenges on how to set up and manage such non-traditional instruments appropriately. These requirements and challenges are put forward below in the guidelines.

Most of the external finance -- whether through traditional or non-traditional tools -- is undertaken in the form of credit financing (or credit guarantees). The FEED delegates stated that equity type of financing is still rather an exception, as the sources here are facing a number of obstacles. These are related to:

- A lack of equity culture in the Baltic countries
- The unwillingness of the entrepreneurs to share ownership
- The lack of exit mechanisms
- Inappropriate legal environment for equity finance
- An overall lack of fund managers able to run commercially viable funds in the present local conditions
- The lack of innovative new policies to encourage private equity provision.

3. Identifying Market Gaps

Delegates noted that it was a highly challenging task to identify where public funding schemes were most needed. There was agreement that such schemes should only be used in cases of market failure. Yet, the experience has shown that the occurrence of market failure is a dynamic and often elusive notion. Before the financial crises, banks had slowly started to extend credits to smaller business and to become more active outside the major cities. Subsequently, due to the financial crisis in 1998 many commercial banks again stopped extending credits to small business due to the banks' decreasing capacity to take risk and a lack of liquidity. The financial gaps therefore again increased, creating larger needs for alternative financial tools. Delegates concluded that identifying market failures was a dynamic and multidimensional task, which needs to take into account changes over time, different needs of different enterprises, different development stages and a number of other micro- and macro economic factors, as for example, differences between regions. These issues need to be borne in mind when evaluating the availability of funding to SMEs.

POLICY GUIDELINES AND RECOMMENDATIONS ON FINANCIAL INSTRUMENTS FOR START-UPS AND SMEs

1. Seek to strengthen the banking and financial system, and improve the availability of funding for SMEs.

1.1 Recognise that any well-functioning market economy needs a strong system of banks and financial intermediates, functioning on a fully commercial basis and as a general principle all SME funding policy initiatives should be consistent with this objective.

1.1.1 Strengthen the banking system and make it competitive to have it develop in the longer term into the basic source of external finance for start-ups and SMEs.

1.1.2 Base financial support instruments insofar as possible on the involvement of private sector banks and funding institutions.

1.1.3 Seek to use the skills and network of the banking sector in providing funds to SMEs.

1.2 Provide training to staff in commercial banks on how to do business with new and small business.

FEED Delegates emphasised the importance of good training and information exchange between, on the one hand, policy-makers and state agencies dealing with SME funding and, on the other hand, the commercial banks. Such training can be undertaken in co-operation with institutions like the EBRD providing credit windows for SMEs to commercial banks in order to have a sufficient incentive for the bank to change their banking practices. These training measures need to be integrated and linked into the overall efforts to make commercial banks more interested in the SME sector as a profitable area for business. Training for bank staff will only be beneficial if bank management promotes a credit policy allowing small credit deals. A good example of fostering this relationship between different actors is the information exchange with Estonian commercial banks organised by the Estonian Rural Credit Guarantee Fund. Information exchange creates awareness and understanding and can be a good precursor to more substantive training programmes.

1.3 Ensure that essential legal conditions and well-functioning implementation systems that do not create inappropriate impediments to funding for SMEs exist, for example, in areas such as:

- Banking supervision rules
- Registration of businesses, lending institutions
- Collateral systems
- Leasing regulations, etc.
- Bankruptcy, receivership, liquidation procedures.

The Baltic FEED participants agreed that improving systems and suppressing unnecessary legal barriers to the functioning of financial intermediaries can have overall benefits on SMEs that are at least comparable to those of targeted financial support programmes. Moreover, removing such legal barriers often does not use up scarce public financial resources. For example, banking laws stipulate in some countries that the collateral for a credit must be more than 100 % of a loan, which makes start-up credit financing rare. Recognise that one option to decrease such legal barriers is to further distinguish the type of credits (for example between long-term investment finance and short-term receivable financing when defining minimum collaterals within the framework of banking supervision rules).

1.4 Create an environment that will allow foreign direct investment in the national banking system.

1.4.1 Influence competition positively by enabling new players (both domestic and foreign) to become involved in the financial service sector.

1.4.2 Bring transfer of know-how on how to best manage banking activities in this sector. This can also lead to showing that there can be commercial sense to dealing with small businesses.

2. Provide selected financial services through public policies where the private sector fails to meet the needs of SMEs.

2.1 Ensure that state-supported financial assistance programmes are set up only where they would not displace private sector financing available on commercial terms.

2.2 Systematically and regularly identify what the real financial needs of entrepreneurs are and whether a sufficient commercial supply already exists, through for example:

- Surveys of SMEs (start-ups, developing, high growth and mature SMEs) and close liaison with representative associations
- Close contact and dialogue with banks and funding institutions.

2.3 Avoid copying financial tools from other countries without taking full account of the present local conditions.

2.4 Co-ordinate the delivery of financial instruments with other SME support instruments such as advisory services, incubators, training centres, etc.

2.4.1 Recognise that a co-ordinated approach allows the overall system to deliver an integrated package of assistance that entrepreneurs need.

2.4.2 Recognise that the needs of entrepreneurs vary and change over time, therefore, the whole system of SME support, including the institutional set-up, needs to evolve and react to these changes coherently.

3. Put priority on measures that will improve access to finance by SMEs and encourage the provision of a broad range of financial instruments, for example:

- **leasing**
- **loan guarantees for fixed asset investment and working capital**
- **venture capital (including seed capital)**
- **factoring.**

3.1 Recognise that the priority need for most small businesses is access **to finance** and not the reduced cost of finance. Government programmes often place too much priority on subsidising interest rates.

3.2 Encourage the use of non-traditional financial instruments as they contribute at least in part to the long-term development of the commercial financial system.

3.2.1 Provide non-traditional financial instruments where the private sector does not meet needs -- this can be in the form of 'demonstration' or pilot projects for the commercial banks.

3.2.2 As commercial banks actually step into this new market, the non-traditional institutions should seek to sell their credit portfolio to the banks and start to engage the resources released into new niches not covered by the banks.

4. Develop loan guarantee schemes and institutions to improve the access to finance, and encourage commercial banks to provide loans to selected SMEs.

- 4.1 Seek to promote credit guarantees when access is restricted and/or interest rates appear to be too high. Guarantees can decrease the component of interest rates covering the risk of business ventures.
- 4.2 Counter-guarantees provided by state sources to credit guarantee funds, when managed appropriately, may allow small businesses to benefit at a low cost.
- 4.3 Review the wide use and experience of existing loan guarantee schemes in OECD and transition countries.

5. Seek to foster new attitudes to SMEs amongst banks and other credit institutions, and link this approach with the provision of new funding mechanisms.

- 5.1 Promote an entrepreneurial and small business friendly culture in banks. This often will call for banks to have an explicit strategy on SMEs and bank staff having a better understanding of small business.
 - 5.1.1 Promote co-operation between banks and SME agencies.
 - 5.1.2 Promote bank staff training. (for example, the Latvian Guarantee Agency organised 12 extensive seminars in 1998 for entrepreneurs and staff from banks and leasing companies).
- 5.2 Encourage the provision of leasing and factoring facilities.
 - 5.2.1 Leasing is often the only source of long-term investment capital financing, in particular, for start-ups that are not able to offer traditional collateral. There has been, for instance, a considerable increase both of leasing as well as of factoring transactions in Latvia and in Poland.
 - 5.2.2 Foster industry associations that will share experiences and develop financial instruments, for example, in order to promote the development of leasing, a Leasing Companies Association has been set up in Latvia.
- 5.3 Ensure that there is variety of non-traditional instruments available to respond to the wide variety of financial needs of enterprises. Avoid the common situation to offer just one or a few financial instruments, which often will not fit the needs of businesses in different sectors and different stages of development.
- 5.4 Provide specific instruments to take into account the need to foster innovation, as well as the promotion of exports and imports to promote regional integration (the group recommended that this area will be dealt with by the Baltic FEED in more detail in the year 2000).

Promoting SME development by providing loan guarantees

“In Poland, the National Guarantee Fund co-operates with 42 banks (1,200 branches), that now increasingly become competitors to the Guarantee Fund. This development, according to FEED Delegates from Poland, has to be seen as a sign that the Fund has been successfully influencing the overall Polish banking system.

Another example of loan guarantees being used to stimulate rural SMEs in Estonia was outlined at FEED meetings. Surveys of SMEs in Estonia point to the fact that the lack of financing, which is often caused by the lack of proper collateral is one of the most important impediments to enterprise development. The Government of Estonia has founded a number of institutions and programmes to ease the financing difficulties for small enterprises and agricultural enterprises and to form the basis for balanced development of different regions.

In 1997, according to the agreement between the Estonian government and the European Commission, the Rural Credit Guarantee Fund (RCGF) was established with the aim to promote investments outside major cities and to the agricultural sector. The Fund can guarantee up to 60% of the loan amount on condition that more than 50% of the share capital belongs to the Estonian resident and private sector. Before the Guarantee Fund began its operations, the main support tools had been loans with reduced interest rate, interest compensation and business advice. A limited number of surety bonds had been also issued by other state funds.

Generally speaking, in the case of surety bonds we can speak of joint liability between the borrower and the guarantor, whereas in the case of guarantees, the guarantors liability comes in addition to that of the borrower. It is important for the Fund that the principle of primary liability of the borrower is maintained. Otherwise the borrower's motivation to pay back the bank loan may decrease and the bank motivation to get back the maximum loan amount in realising the borrower's collateral may decrease as well.

The first RCGF guarantee was issued in autumn 1997. The initial steps in launching the new product in the market were difficult, which was aggravated by the fact that the target group was limited to long-term bank loans to enterprises with at least two years history and positive economic results. Beginning from the second half of 1998 the number of guarantee applications has increased rapidly. On the one hand, this is connected with the change of economic environment for the worse, which has motivated the credit institutions to find additional possibilities for sharing the risk. On the other hand, it has been supported by the active PR of the Guarantee Fund and the introduction of new products to the market (guarantees to short-term loans, factoring, start-up companies).

Compared to other support tools, guarantees are relatively inexpensive for the state. The total loan amount guaranteed by the RCGF was 114 million EEK² as of 31 October 1999. One loan guarantee (270,000 EEK) is in the process of being paid out. The losses would be covered by the fund itself from the received guarantee fees. The charges range between 1.5 and 2 per cent annually on the guaranteed amount outstanding.

The Guarantee Fund co-operates with all Estonian commercial banks that are active in lending outside the capital and with two major leasing companies. The banks or leasing companies perform the first screening of the projects and apply for an additional guarantee from the Fund when they find it necessary. About one quarter of the guarantee applications has been rejected by the Fund. The average guaranteed loan amount is approximately 770,000 EEK and the average guarantee amount is approximately 434,000 EEK. The smallest guaranteed loan was 40,000 EEK and the biggest 8 million EEK. The fund has five employees. The Guarantee Fund aims to triple its guarantee portfolio in upcoming years. “

Ms. Maive Rute, Chief Executive Officer, Estonian Rural Credit Guarantee Fund, Estonia, at the FEED meeting 1999

² The exchange rate has been fixed at 8 EEK = 1 DEM. For comparison, in 1997 the total amount of new long term bank loans to agricultural enterprises was 44 mln EEK and to forestry 25 mln EEK. The investments financed by capital rent (leasing) amounted to 128 mln and 46 mln EEK.

- 5.5 Promote conditions to facilitate equity finance and, in particular, venture capital.

Venture Capital is an important tool for SME development, although often more appropriate in later stages of the transition process. In the Russian Federation Regions, according to delegates from Kaliningrad and St. Petersburg, this would require changes in the registration of foreign investors and in the legal regulations concerning put options as an important part of the financial contracts between the entrepreneur and the venture capital fund.

Some OECD Member countries have promoted Venture Capital through Public/Private Partnerships. The state can have a role in supporting private actors financially by setting up Venture Capital Funds. In European countries, this has involved risk sharing by the state of between 30% - 50% both of investment capital as well as operational costs of running the fund. The private investor still needs to take a considerable share of the risk in order to avoid incentive distortions.

Comments by delegates at the FEED meetings 1999

- 5.6 Promote a legal framework that is open to sharing ownership with outside investors.

- 5.7 Consider using tools for finance that are fulfilling social and employment objectives.

The most important examples here are micro-credit schemes and credits or grants for the promotion of self-employment. Analyse carefully the costs and benefits of these schemes. Micro-credit and self-employment finance fill market gaps which most probably will not satisfy commercial banks even once they have rapidly increased their competitiveness. Take advantage of the experience of OECD Member countries in this area which have shown that only some of the schemes -- those that follow a range of stringent success criteria -- were able to create added value.

Comments by delegates at the FEED meetings 1999

6. Ensure that good business practice and systems are followed when disbursing public funds to support SMEs.

- 6.1 Take active measure to make any such funding organisation and its services widely known and thereby accessible also by a wide range of entrepreneurs.

6.1.1 Co-operate with other SME promotion services to advertise the service of the fund.

6.1.2 Inform SMEs and advertise the services through newspapers, commercial banks and directly to enterprise associations and chambers of commerce.

6.1.3 Disseminate brochures and booklets and participate also at regional and local events in the area of entrepreneurship promotion (such as the enterprise days of a parish or a county held on occasion in Estonia).

- 6.2 Establish rigorous and transparent assessment and selection procedures on funding programmes supported by public funds.

6.2.1 Avoid the formulation of sector-oriented selection criteria.

6.2.2 Allow for the provision of training for members of credit boards not having longstanding banking or business experience.

6.3 Make sure that the management of SME support funds is performed by professional staff.

6.3.1 Avoid where possible that public officials (who may lack the credit analysis skills) are involved in decisions on distributing money.

6.3.2 Set performance targets in order to measure the impact of aid in relation to the objectives.

6.4 Ensure that there is private sector participation in the funds.

Private sector participation can be brought about, for example, through including representatives from business or business associations in the boards of funds or in local advisory groups of funds. This will help to channel expertise and the knowledge of grass-roots business conditions from business people to the fund management. For example, the Estonian Association of SMEs (EVEA) has representatives on the board of the Small Business Loan Fund, as well as in the regional development agencies.

6.5 Link credit decisions to risk.

6.5.1 The public allocation of money to the private sector has proven to be difficult, and in a number of cases such credit funds have poor repayment rates.

6.5.2 Set up incentive schemes that motivate those taking credit decisions to achieve good repayment rates so that funds become available again to other small businesses.

6.5.3 Do not go to the other extreme of public schemes, limiting their credit to low risk businesses in order to have a high repayment rate. In this case, the development objective is not accomplished and public support cannot be justified, as those low risk businesses often have been able to attract commercial finance.

7. Provide training and advice for entrepreneurs and staff in SMEs in dealing with financial institutions and loan applications.

7.1 Provide training and advice to entrepreneurs on dealing with financial institutions and funding agencies -- this is a prerequisite for a better functioning of the whole financial system as it will lower the transaction costs for the financial intermediaries.

7.2 Link training and advice with financial services where appropriate.

- Value can be added in financial schemes, which are linked to the entrepreneur receiving technical assistance.
- Recognise that this is not possible or useful for all non-traditional financial schemes and needs to be decided on a case-by-case basis for financial schemes.

7.3 Promote networks and exchange between entrepreneurs who are often the best placed to explain to other businessmen how to deal with financial institutions in order to obtain finance. Use such a networking approach in collaboration with business associations.

8. Ensure that access to finance is improved at the regional and local level, and that SME development policy addresses this issue.

- 8.1 Ensure that all policies and programmes dealing with financing small business take into account the spatial dimension of the financing gap. Avoid concentrating efforts in the capital city or main urban areas, as this would increase regional imbalances.
- 8.2 Allow for the building up of financial expertise at the local level. Hence, set up credit support schemes at the local level. That will aid the local commercial banks to take some credit allocation responsibility, in addition to the usual function of cashier. Achieving this will only be possible through continuous lobbying commercial banks at headquarters level.

The local level is appropriate for experimental forms of financial engineering. Examples here are support schemes for business angels in order to foster informal equity or loan capital. The European Commission has promoted a number of such local attempts and the Baltic Countries should take advantage of the experience learned here. Recognise that in addition to a wide-ranging consultation of local actors, it is necessary to carry out research in order to find out the actual needs of SMEs and the deficiencies of the existing products on offer in the region. A lack of such prior research as well as the omission of the setting of clear-cut performance targets were reasons why attempts for innovative financial engineering have failed in some OECD Member countries.

- 8.3 Promote public/private partnerships on the local level. On the local level in particular, it makes sense to bring in public and private actors, as both will take advantage more directly from development progress.
- 8.4 Promote also rural development financing. This is fundamentally important, as the prospect for a commercial supply in these areas is low in the short and medium term. At the same time, it is clear that the sole source of job creation in rural areas frequently stems from the creation and development of small business, including innovative agro-based businesses. A good example of this is the Estonian Rural Credit Guarantee Fund that provides guarantees for banks to extend credits to rural entrepreneurs.
- 8.5 Promote innovative financial schemes at the local level.

In specific cases, preferential credit conditions may be extended. This can include special grace periods (for the principal during the first year of a credit) which are often not available on the commercial market for credits, which favour short-term credits. This is important for many start-ups and SMEs, which have cash flows in the early years that do not allow immediate repayment of a loan or which cannot rely on revolving short term credits. Moreover, in selected disadvantaged regions or for other specific target groups focused interest rate subsidies might be temporarily useful.

V. ADVISORY SERVICES FOR SMEs

1. Background

Working Party II of the Baltic FEED addressed the subject of “Advisory Services for SMEs” as an issue under the general heading of support services and financial instruments. Delegates agreed that the availability of appropriate advisory services was fundamental for the long-term development of the private sector and, in particular, of new and small businesses. Advisory services provide fundamental expertise on running businesses in a market economy and thus provide critical elements to progress in the process of transition.

The theme of advisory services is interrelated with other work areas of the Baltic FEED. For example, programmes to provide finance for SMEs often need to be linked to an advisory component to be successful.

There was a consensus that, fundamentally, business advisory services should be delivered by the market. However, delegates identified critical market gaps in the Baltic countries in a number of areas which policy action should carefully analyse and address.

The discussions of the delegates concentrated on the following questions:

1. In which types of market gaps should the government intervene?
2. By what means should government try to fill the perceived gaps for advisory services?
3. How can long-term sustainability of initially government-subsidised services be reached?
4. How donor funds as well as foreign consultants’ know-how might be best used to set up a national advisory service network?

Deciding where and how government should intervene is a highly challenging task. Delegates agreed that there was no single or general answer to this question. Advisory services for new and small enterprises comprise an extremely heterogeneous range of widely different services and ways on how to deliver them. The needs of SMEs also vary widely in relation to their development stage, sector, location, etc. Therefore, any policy action in this area needs to be based on a thorough analysis of local business advisory services and local needs.

2. Basic Types of Advisory Services

Delegates of the working group adopted a broad view of advisory services. This extends from training in business strategy and operations (including legal, accounting and fiscal services) to consultancy on traditional business topics like marketing, production practices, technology, and finance-related advisory services. This scope reflects the present supply and demand of such services in the delegates’ countries.

Overall, services of low added value, in particular legal and tax training have made for an important share of the spectrum of advisory services. This can be explained by the still adverse legal and fiscal environment, which makes entrepreneurs seek assistance and advice particularly in these areas. Delegates expressed the view that the demand for more sophisticated services was still low -- with many entrepreneurs not perceiving a need for more complex advisory services. This low demand for more complex services is in addition matched by the limited financial means of entrepreneurs starting up a

business or developing their small or medium-sized company. Both factors influence the growth of the SME sector.

3. Critical Policy Issues

The discussions on business advisory services again confirmed the challenge that policy-makers face. There were no single or easy answers, but the delegates suggested an analytical framework for the problems, which lead to the development of policy guidelines.

Delegates agreed that the market for information and advice was not yet transparent and sufficiently developed to allow new and small businesses easily obtain access to those services. Non-transparency and distortions in the market for information create a number of justifications for different types of public intervention in filling the market gaps. Nevertheless, as with any state interventions on the provision of services, it is crucial not to disturb the emergence of a market-driven supply. In addition, state intervention has to avoid that inappropriately targeted programmes offer services where no demand exists.

A core question for the delegates was the extent to which services should be subsidised. This question was closely related to the discussion on the sustainability of institutions and agencies providing advisory services. The experiences of the Delegates show that these questions cannot be answered in one single way. Some donors felt pressure from their ministries of finance to seek self-sustainability, for example, after three years. Often the practitioners felt that such a time frame -- possibly realistic in the OECD Member countries -- would be much too short in transition economies. Moreover, strong pressure for self-sustainability could drive agencies away from assisting new and small businesses, which need the help most, to work more with larger clients that are able to pay for the services.

FRAM – the Norwegian experience

“FRAM is a management and strategy development programme specifically designed to help Norwegian SMEs (SME) on their way to prosperity.

Every year hundreds of Norwegian companies join the programme, and the results speak for themselves; approximately 75 per cent of the participants improve their profitability by 5 per cent or more of their annual turnover during the 15 months’ duration of the programme. An even larger percentage of the participants carry out extensive improvement measures in order to strengthen their position on a long-term basis, indicating that there clearly is a scope for such a programme for SMEs. FRAM is about making the right priorities when it comes to management and strategy. However, it does not necessarily mean more work. It is important that the company is willing to make its own decisions, carry out the necessary changes and indeed to follow up the results. A major part of the FRAM-programme is the regular company workshop, during which the participants are given valuable professional input, and have the opportunity to engage in discussions of mutual interest. In between company workshops, the companies are assisted by advisors on an individual basis. The tools used are simple and practical, and the method is well tested. An extra bonus is the valuable contacts established with other companies during the programme.

FRAM offers three development models, dependent on the size of the company and what challenges it faces. The classification of each company will ensure that the managers are grouped with others in situations similar to their own. The FRAM programme is offered to companies all over Norway. The projects within the programme are carried out by local advisors and companies from the same geographical area. The companies in one group represent a cross-section of trades in order to avoid that competitors participate in the same project. The programme is run by the Norwegian Industrial and Regional Development Fund (SND in its Norwegian acronym).”

Mr. Jostein Djupvik, Adviser, Industrial Policy Department, The Royal Ministry of Trade and Industry, Norway

POLICY GUIDELINES AND RECOMMENDATIONS ON ADVISORY SERVICES FOR SMEs

1. Identify and review regularly the type of services that small businesses need and build and adapt SME policy on business advisory services accordingly.

1.1 Assess the needs according to the different conditions of small businesses taking into account the:

- Development stage and type of company (e.g. pre-start-up, start-up, early development stage, expansion stage, established mature stage, high growth company, etc.)
- Sector
- Technology intensity
- Local economic environment
- Experience and competencies of the entrepreneur
- Other relevant factors.

1.2 Identify the needs of small businesses in an objective and systematic manner. Base the identification of business advisory service needs on local surveys.

The Panevezys Business Centre (Lithuania) has identified the following areas in which market gaps and needs for services exist.

(a) For prospective entrepreneurs and people considering business ideas

- **Information on legislation**
- **Registration preparation**
- **Patent assistance**
- **Registration assistance**

(b) For start-ups

- **Bookkeeping and accounting advice**
- **Advice on legislation**
- **Business plan preparation**
- **Business auditing**
- **Market research**
- **Marketing advice and services**
- **Working with business directories**
- **Identification of business partners**
- **Internet support**

(c) Training and Seminars for existing SMEs

- **Computing**
- **Accounting**
- **Business organisation**
- **Business planning**
- **Market research**
- **Successful selling**
- **Opportunities of the Internet**
- **Foreign languages**

1.3 Recognise that other important areas where advisory services may be needed are:

- information technology
- technology know-how
- opportunities through technology transfer
- import/export opportunities/barriers
- joint ventures
- product development and innovation.

1.4 Ensure that advisory services and, in particular, associated training modules are of direct concern and relevance to the practical problems that entrepreneurs are facing.

An example of such an attempt is the Kaliningrad “DYB” (Develop Your Business) programme, which uses real business problems of the participants as the basis for case studies. The role of the teacher in the course is to provide practical management and marketing tools that are directly used and tested by the participants on their usefulness in real world situations.

1.5 Recognise that a needs assessment may go beyond the direct requests and needs perception of entrepreneurs.

- Clarify if there is a broader need for training and advice of entrepreneurs and SME staff, which they do not perceive due to a lack of know-how.
- Ensure that whenever such pro-active needs' assessments are undertaken, a 'reality check' with entrepreneurs is performed to avoid government officials or donor programme promoters suggesting perceived needs of entrepreneurs which are not market oriented.

1.6 Involve business associations in the identification of entrepreneurs' needs -- use networks and longstanding experience in determining the needs of businesses.

2. Intervene only where market gaps exist in the provision of business advisory services.

2.1 Follow a general policy of providing state intervention schemes only where there is a clear market deficiency in the provision of business advisory services to start-ups and SMEs.

2.2 Design and implement advisory services, taking into account linkages to other development programmes and business support infrastructure.

2.2.1 Business advisory services need to be linked carefully to other support measures in the overall policy design of SME policies and delivery. Advisory services need to be seen in close relationship with other needs of entrepreneurs, for example, on finance, premises, technology transfer, etc.

2.2.2 Consider the provision of related services 'under one roof'. Advisory services, business incubators, financial services, technology transfer can frequently be integrated to maximise cost-effectiveness and to deliver the full range of services needed by the entrepreneur.

2.2.3 Recognise the importance of enterprise networks. Entrepreneurs can usefully exchange know-how amongst each other and thereby satisfy a lot of their advisory needs.

Agencies involved in the provision of advisory services can have an important role in building such networks. An example is the Baltic enterprise network set up with support from SIDA and the Swedish Management Institute.

2.2.4 Recognise that the combination of advisory services with financial services can create synergies. Often advisory services will be taken up, remunerated and used more professionally if related to the possibility of obtaining a credit or a credit guarantee.

2.3 Ensure that there is transparency and coherence for the overall system of business advisory services and SME management training.

- Ensure that entrepreneurs can easily learn about the existence and quality of programmes.
- Make sure that the overlap of different programmes only takes place where there are clear complimentary programmes, or demand is sufficiently high.

3. Specify in SME development policy the aims and reasons for government intervention in filling these market gaps.

3.1 In addition, measure the additional costs of state intervention versus the economic benefits engendered through additional economic development, job creation or other policy objectives.

3.2 National, regional and local governments need to follow the above principles when deciding to provide business services.

4. Involve the private sector, as early as possible, in the provision of business advisory services with the objective that in the long run the private sector should become the prime supplier of business advisory services.

4.1 Ensure that programmes encourage the private sector provision of advisory services wherever possible. Avoid setting up subsidised and competing services where private actors are emerging and trying to become financially viable.

4.2 Concentrate scarce public funds on providing services that are not commercially attractive for the private sector as, for example, advisory services and training for start-ups, consultancy for SMEs in economically disadvantaged regions and minority groups. There is a need for a clear and transparent policy strategy determining which enterprises should benefit from subsidised services.

4.3 Recognise that public intervention in the area of business services needs to include capacity building for private sector actors.

4.3.1 In some cases, the policy objective to provide needy small businesses with advisory services and, at the same time, to build capacity of the business advisory service industry, might best be fulfilled by providing vouchers.

4.3.2 Arrange private sector provision of business services where possible, for example, in the form of sub-contracting or modules of programmes.

- 4.4 Build partnerships with other institutions and actors on the local level.
 - 4.4.1 Seek participation of local governments, local business associations, local enterprises, local universities and other vocational training providers to co-operate and to support the business advisory programme
 - 4.4.2 Recognise that wider local ownership of the project will help to achieve sustainability. Moreover, this will contribute further to capacity building at the local level.
- 4.5 Be cautious about the use of accreditation systems for business advisors. Rather, seek to publish lists of consultants with their training background in order to create some minimum awareness and transparency.
- 5. Use good commercial practices and procedures in managing and operating business advisory programmes and institutions.**
 - 5.1 Establish business advisory service programmes as independent entities, so that they can be operated like businesses, rather than like administration providing government services or like traditional donor programmes.
 - 5.1.1 Establish support programmes as separate and transparent entities -- this helps to better identify and manage cost structures and, especially, overhead costs.
 - 5.1.2 Operate programmes in a business-like manner (e.g. business plan, management board, MIS, systematic approach to quality delivery of services and service, etc.). This will facilitate financial sustainability. Moreover, businesses will value advisory services higher when they come from a business-like organisation.
 - 5.1.3 Make subsidies in support of business advisory services explicit and foreseeable. The subsidies given should have a definite time-span or should be related to clearly established performance parameters.
 - 5.2 Recognise that enterprises should pay for services and that free services should, in general, be restricted to information provision.
 - 5.2.1 Distinguish clearly between general information and initial screening sessions, which may be provided for free or at a low, symbolic price, and full business consultancy services, which should be priced at least to cover costs. Providing the latter for free over any extended period could have a negative impact on the emergence of a commercial supply for business services.
 - 5.2.2 Recognise that fees help to develop sustainable organisations and, in addition, are a reliable test on whether services are actually meeting customers' needs.
 - 5.2.3 Make exceptions or cost cuts only for particular target groups like micro entrepreneurs or in the case of entrepreneurs in particularly disadvantaged regions -- this will be the case for a large part of the rural areas in the Baltic countries. Moreover, there might be a need to subsidise training and advisory services for pre-start ups and selected start-ups that do not have the means to pay for services at this stage.

5.3 Conduct regular surveys of the actual use of advisory services by SMEs, and their present needs in order to:

- Ensure the suitability and satisfaction with the delivery of services
- Identify changing needs
- Adapt and improve the design and delivery of services constantly.

5.4 Advertise the services offered by such programmes and institutions professionally and seek to set up a positive image and reputation of the services towards the private sector.

6. Aim for sustainability in the design and organisational structure of business advisory service programmes.

6.1 Establish sustainability as a key aim and key consideration in the design of the organisation.

6.2 Seek to follow an organisational strategy of building good internal competence -- delivery institutions might be sustainable even if support programmes are discontinued because they have been able to build up competence, which can be sold commercially or used for other support programmes.

7. Seek to diversify funding sources that will contribute to the continuity and enhancement of the programmes.

7.1 Enhance sustainability by having multiple sources of income, particularly through support from the local level. The more diverse the funding sources are structured, the higher the probability of sustainability and long-term survival.

8. Put priority on the selection, training and ongoing supervision of staff delivering business advisory services.

8.1 Make sure that the selection, training and supervision of staff for business advisory services are undertaken appropriately.

8.1.1 Undertake in-depth analysis of the training needs of business advisory staff.

8.1.2 Make sure that any donor-funded foreign consultants invest as much of their time spent on transferring their know-how to local staff, as they do on project work.

8.1.3 Provide business counsellors with a firm grasp of basic business functions, such as accounting and finance, marketing, personnel management, production methods, including counselling and group moderation skills.

8.1.4 Provide adequate equipment to support the delivery of business advisory services.

8.1.5 Encourage linkages with universities – these can greatly increase the range of know-how that advisors can make available to enterprises.

9. Ensure that adequate budget resources are provided for the selection and training work.

- 9.1 Provide sufficient initial funding to allow the attraction and training of high-quality staff.
- 9.2 Recognise that investment in staff training and skills development is an investment in delivering better services to SMEs and in ensuring sustainability of the advisory services programme.

10. Recognise that the promotion of business advisory services is another important form of human capacity building, which is crucial for successful long-term development of the whole economy.

- 10.1 A strong business advisory service countrywide can contribute to SME sector and regional development.
- 10.2 Seek to ensure that all such services have the aim of building indigenous skills and knowledge.

Avoid transferring training and advisory concepts from the OECD Member countries without checking their appropriateness for the local conditions. Foreign advisors therefore have to first learn more about the specific situation in transition countries before starting to train the local consultants and advisors. This has been proven to be vital in areas that strongly differ from the economic and institutional structure of the OECD Member countries as, for example, in the Kaliningrad region.

Mr. Gueorguij Dykanov, Post-Privatisation Centre in Kaliningrad, Russian Federation, at the FEED meeting 1999

VI. REGIONAL AND LOCAL ENTERPRISE PROMOTION

1. Overview

Regional and local enterprise development has become more of a priority on the policy agenda in Baltic countries in recent years. This is due to the important spatial differences in economic development as well as the need to adapt entrepreneurship promotion strategies and tools to specific local conditions in order to make them efficient. In addition, the pre-accession negotiations have focussed attention on the importance of regional policy in the Baltic countries as policies need to be adapted to possibly take advantage of the EU structural funds upon membership.

The Baltic countries have been experiencing increasing regional and local disparities. There is need to tackle economic decline at both the urban and at the regional level. There is a legacy of the distorted and artificial territorial structure of Baltic economies before the transition process, which was created during the period of central planning. For example, where the economic base of an area was mono-industrial and most employment depended on now defunct armaments of steel-making plants, textile mills, or agricultural collectives, or where geographical isolation and inadequate infrastructure inhibit development based on inward investment and enterprise creation. One of the examples of territorial imbalance is the difference between the capital of Latvia, which has 40 per cent of the population and a relatively high entrepreneurial activity compared to the rest of the country.

2. Regional and Local Development Policies

It is not economically efficient to seek to remove regional disparities fully, but where they exist there can be high cost in terms of social unrest, rapid migration waves, political instability and resistance to economic reform policies when disparities become too large. Therefore, the policy challenge to manage better the spatial distribution of economic activities is an essential policy area -- an important policy field also in most OECD Member countries. There is no common view in the OECD Member countries or in Baltic transition countries on when disparities become too high and to what extent resource development programmes should be used. Nevertheless, work of the OECD and case study experience at FEED meetings has shown that there are some good principles to point to avoid ineffective policies.

FEED Delegates recommended designing entrepreneurship policies at the grass-roots level in order to adapt them to specific local needs. The advantage of such an approach is the proximity to the real problems and opportunities of local entrepreneurs. It is difficult to have an accurate knowledge of the reality of issues facing entrepreneurs from the central level. Policies to promote entrepreneurship based solely on central design and implementation have proven to be ineffective in the past. Moreover, central programmes often tend to limit their coverage to businesses near the capital where support may be less needed.

In response to this challenge, countries in the Baltic region have set up regional policies and programmes. Entrepreneurship policies and SME promotion are a centrepiece in these policies. Regional subsidies, regional employment and social policies as well as infrastructure policies complement them. For example, Latvia has adopted the law "On Assisted Regions" in May 1997 which defines principles on how to identify assisted regions, how to choose the development instruments, and how central and local governments are supposed to co-operate on these projects. In Lithuania, the national SME Development Programme states that coherent regional development is a major objective. Small business development and regional development therefore are, also in the other participating countries and regions, closely linked through both policy design and implementation.

A fundamental shortcoming mentioned by delegates was the considerable gap between the objectives formulated by national, regional and local governments in enterprise promotion and the actual resources, which are available to implement these policies.

In addition, delegates pointed to the problem that the analysis of the local and regional economic basis of enterprises and the formulation of regional development strategies was often unsatisfactory. Kaliningrad was cited here as an extreme example, where for years no thorough structural economic analysis has been undertaken, which could serve as a basis for a systematic entrepreneurship promotion policy formulation. Overall, there was the impression that local and regional policies for the promotion of entrepreneurship were in an initial phase of development and fundamental progress still needed to be made in this area.

3. Appropriate Infrastructure Provision as a Precondition to Economic Development

The delegates of the Baltic FEED agreed that physical infrastructure (transport networks, telecommunications, power and water supply, sewage systems, etc.) was a precondition for economic development and therefore particularly important for the local and regional level as the provision of infrastructure was often not homogeneous. In a number of areas, considerable progress needs to be made in the Baltic countries, as well as the participating regions of the Russian Federation. In order to better concentrate the FEED work and to best take advantage of the experience of delegates, the group decided to focus solely on the business environment at the regional level, recognising that physical infrastructure must be sufficient to support enterprise development.

4. EU Pre-accession

The whole area of entrepreneurship promotion policies and regional economic development -- as far as the three Baltic countries are concerned -- increasingly needs to be analysed within the context of pre-accession negotiations. As potential members of the European Union, the Baltic countries will become subject to the EU Structural Funds, which would fundamentally reform national policies. A number of preparatory programmes are already underway to help the countries with a smooth transition, for example, within the framework of the EU PHARE Programme. Similar to the procedure in EU member countries, Latvia has to prepare a National Development Programme (as in objective 1 countries like Ireland, Portugal, etc.) in which regional and local support of new and small businesses play an important role. The changes coming due to the accession to the EU, therefore, might bring some of the necessary new momentum to improve the entrepreneurial climate on the local level.

EU accession implies new policy challenges for actors at the local level. Delegates stressed that there is a need for sustained effort for capacity building. For most of the local actors, whether private or public, at present the potential impact and required changes are unclear. The Baltic FEED can play a critical role in the coming years in contributing to this capacity-building exercise through policy dialogue and exchange of experience among its member countries as well as with other countries outside the region which are involved in the EU accession process.

5. Business Incubator, an Example of a Tool for Regional and Local Enterprise Promotion

Business incubators help entrepreneurs to start businesses by making the process simpler and less expensive. They feature commonly shared building, administrative and communication services, and, depending on specific circumstances, can be associated with universities, technology parks, etc. The advantages of business incubators for entrepreneurs include reduced initial investment in premises, reduced overhead costs through sharing of administrative and communication services, benefiting from interaction with other entrepreneurs in the incubator, and expertise in dealing with government institutions and agencies. Entrepreneurs can normally use the incubators only for a limited period.

POLICY GUIDELINES AND RECOMMENDATIONS ON REGIONAL AND LOCAL ENTERPRISE PROMOTION

1. Formulate and implement a coherent regional and local development strategy.

- 1.1 Formulate a clear regional development policy, including the objectives and priorities of this policy.
- 1.2 Set up measurable, objective criteria for eligibility.
- 1.3 Adopt a long-term perspective of support under regional development policy.
 - 1.3.1 Seek a long-term approach based on the promotion and development of local enterprises, including micro-enterprises. This does not exclude short-term measures that are sometimes required to cope with economic difficulties.
 - 1.3.2 Recognise that it is important to link short-term measures into a more long-term strategy.
- 1.4 Create competent institutions for managing regional development policies.
- 1.5 Support local entrepreneurship and SME promotion by leading, empowering, allocating and facilitating. Doing this successfully requires a constant balancing between government leadership and central state authority on one side and decentralisation and local capacity building on the other.
- 1.6 Take advantage of the pre-accession procedure and the special preparatory Programme of EU Structural Funds to strengthen the coherence, sustainability and resource allocation of national regional development strategies.
 - 1.6.1 Analyse the changes that are necessary in the area of regional policy and programmes in view of preparing for accession to the European Union.
 - 1.6.2 Ensure smooth adjustment of present policies.
- 1.7 Recognise that there is often a need to redefine administrative structures and regional responsibilities as a precondition to formulating a coherent national regional development policy.
- 1.8 Recognise the importance of cross-border co-operation within the Baltic countries.

Interregional co-operation needs to be further increased to better contribute to regional integration in the Baltic area. In addition, well-structured cross-border co-operation projects will have an immediate impact on efficiency in the participating regions. Co-operation with neighbouring regions would help to take advantage from synergies and agglomeration effects necessary for the successful promotion of entrepreneurship and small businesses.

Comments by FEED Delegates at Baltic FEED meetings, 1999

2. Research and assess the specific regional and local environment in advance in order to inform and guide the preparation of regional policy.

- 2.1 Base any strategic planning of local entrepreneurship promotion on careful stock taking of the locality or region and in particular on:
 - Specific local context and culture
 - Local economic structure
 - Local labour market
 - Physical environment and infrastructure
 - Ongoing entrepreneurship promotion activities.
- 2.2 Analyse the strength and weaknesses of the local economy and local SMEs.
 - 2.2.1 Audit the effectiveness of ongoing policies and promotion programmes.
 - 2.2.2 Review the resources available for entrepreneurship promotion.
 - 2.2.3 State strategic objectives for regional economic development.
 - 2.2.4 Relate objectives to the area's problems and opportunities and to the available resources.
 - 2.2.5 Avoid setting unrealistic targets.
- 2.3 Draft an action plan spelling out the specific actions to be undertaken to meet the strategic objectives and determine the priorities for action.
- 2.4 Ensure that the actions are well co-ordinated and that no conflicting or contradictory action occurs within the area.

3. Undertake measures to promote the entrepreneurial climate at the local level.

- 3.1 Ensure that the entrepreneurial climate is promoted at the local level, as it is on this level where small businesses mainly operate.
- 3.2 Foster entrepreneurial spirit at the local level.
 - 3.2.1 Increasing the awareness for entrepreneurship needs to take into account the local culture.
 - 3.2.2 Action to improve entrepreneurial spirit is particularly necessary in remote rural and other backward areas and mono-industrial areas that were characterised by decades of absence of entrepreneurial activity.
- 3.3 Ensure a good provision of business services at the local level. Most entrepreneurs will be able to use business services only when they are available locally and delivered near to their location.
- 3.4 Remove entrepreneurial obstacles at the local and regional level. Local and regional government can do a lot to improve the environment for entrepreneurship by removing inappropriate regulation and administrative barriers.

3.5 Promote small firm and large firm linkages.

3.5.1 Local linkages or backward linkages are critical to strengthen sustainable economic development. They are fundamental in order to reap the full economic advantage from foreign direct investment.

3.5.2 Organise such linkages on the local level around local poles of competencies using the experience from cluster building.

3.6 Avoid concentrating local economic development on the largest local employers. Do not limit local economic development to the promotion of industrial development.

3.7 Promote public/private partnerships at the local level. Public/private partnerships at the local level can be critical tools to promote entrepreneurial spirit and, at the same time, to free financial and human resources for local development objectives.

4. Promote capacity building of regional and local institutions.

4.1 Build success of entrepreneurship promotion on the local level through a long-term policy of capacity building. This needs the existence of capable regional partners. Capacity building needs to be targeted at the key actors of the local community, including:

- Local government officials
- Representatives of local political parties
- Local businessmen
- Representatives of employers' and trade unions
- Local development and training practitioners
- Representatives of banks.

4.2 Recognise that there is a risk that local actors limit local development to the pure provision of local physical infrastructure and do not focus on improving the local framework conditions for entrepreneurship. This capacity building includes the following elements depending on the development state of a community:

- Training and know-how provision, relating to economic development
- Consensus building and conflict resolution
- Project management.

4.3 Awareness creation and training need to be targeted both at public officials as well as at private entrepreneurs, particularly, in order to prepare for successful private/public partnerships.

An example of this capacity building are the economic educational programmes organised by the Latvian Regional Fund that spent 10 per cent of its overall resources on capacity-building.
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4.4 Increase transparency and information about programmes available to the entrepreneurs at the local level.

5. Facilitate and support the emergence of financial institutions at the local level.

- 5.1 Audit the supply of finance on the local level. Avoid local banks functioning simply as cash depots with no credit authority.
- 5.2 Set up local non-traditional funds if a considerable market gap exists at the local level. (See part of the guidelines on financial instruments).
- 5.3 Credit unions and mutual funds often provide for the particular need for additional non-traditional financial sources at the local level. Take advantage of the extensive experience of FEED members in this area and try to base local approaches on locally adapted best practices.

6. Maximise the role that business incubators can play in the promotion of local entrepreneurship and in assisting start-up ventures.

Good Practice in Business Incubation

Local Economic and Employment Development (LEED) Programme

“Incubators have variously been referred to as enterprise centres, nurseries, shared workspaces, managed workspaces and venture units. As this diverse nomenclature suggests, there is no unique business incubator model. The incubator industry is an assortment of different types of facilities operating under different circumstances. This variety, it was remarked, can be a hindrance both to the collection of statistics and to industry benchmarking.

Evidently, business incubators aim to assist entrepreneurs with enterprise start-ups and development. However, the underlying objectives of business incubation are varied. They have included, for example: combating unemployment; expanding the supply of infrastructure; commercialising university research; upgrading the technological capabilities of firms in a given location; assisting socially disadvantaged groups - such as youth and minorities --, and even providing a protected space for entrepreneurship in areas where crime is a constraint on business. The public, private and non-profit sectors have all participated in establishing incubator schemes. Local and regional governments, universities, chambers of commerce, science parks and private real estate developers have all funded incubation programmes.”

A Synopsis of the Presentations and Debates, International Conference in Albi, France, 14 - 15 October, 1999, OECD LEED Programme

- 6.1 Ensure good governance and management structures and set up a clear and realistic mandate in line with the resources of the business incubator and local economic conditions.
- 6.2 Involve local partners like large enterprises, universities, business associations and consultant companies, and focus the activities of the business incubators on local entrepreneurs and their needs.
- 6.3 Select the site carefully and ensure suitable infrastructure and facilities.
 - 6.3.1 Assess all relevant factors in choosing a location.
 - 6.3.2 Take care to ensure suitable infrastructure for the business incubator (adequate roads, water, power, etc.).
 - 6.3.3 Balance regional policy demands and the essential requirements for success of business incubators.

- 6.3.4 Establish clear criteria and conditions in choosing locations for business incubators. For example, a local free contribution of premises, a local financial contribution, the legal adoption of the non-profit constitution, described above, by local participants.
- 6.3.5 Adhere to the underlying principle of local contribution and local legal commitment to the constitution/mandate. These principles may vary in implementation from one location to another, but the underlying principle of obtaining tangible local commitment and support is recommended.
- 6.3.6 Provide modern and competitive communications infrastructure. Install good communications facilities (telephone, fax, Internet, E-mail, video conferencing, etc.) that will facilitate business.
- 6.3.7 Plan a full range of services that will meet the needs of entrepreneurs. These facilities/services may be introduced on a gradual basis.

7. Evaluate carefully the full costs and benefits of any proposals to use free economic zones.

- 7.1 Recognise free economic zones mainly as a tool to facilitate foreign trade. Cross-border transactions are still highly cumbersome and free economic zones can facilitate this trade considerably. Therefore, they can have a positive role on economic development, particularly, in border areas.
- 7.2 When using free zones, set up a clear national framework to create transparency of the objectives, tools and costs. Clearly distinguish between economic free zones, duty free zones, bonded warehouses. Avoid the creation of free economic zones that are not a part of a coherent and long-term development strategy.
- 7.3 Use tax exemption carefully in order to avoid creating tax havens without inducing real additional economic activity. Avoid that particular enterprises obtain the status of a tax free zone when it is not clear, why other enterprises in the local area will not obtain the status.
- 7.4 Take advantage of international experience. Success of economic free or special zones is often built on good services rendered to investors rather than tax and customs exemption.
- 7.5 Make sure that free economic zones are accessible and suitable also for new and small entrepreneurs.
- 7.6 Take into account the ramifications of accession to the European Union and avoid setting up free economic zones that will not be accepted by the EU standards.

8. Promote appropriate use of evaluation methods for local entrepreneurship promotion projects.

- 8.1 Recognise the importance of evaluation as a tool to improve the efficiency of entrepreneurship promotion support.
- 8.2 Use evaluation as an integral part of the everyday management of a project or programme. Begin evaluation before day one (ex-ante). This will help to give shape and direction to the activity and will help to easily adapt programmes where changes are necessary.

- 8.3 Recognise that there are a number of different approaches to evaluation and try to cover all these aspects in the evaluation strategy. The key aspects covered by a full evaluation concern the four dimensions of a project or programme below.
- 8.3.1 **Accountability:** To ensure that funds are properly and effectively used in line with the mandate.
 - 8.3.2 **Management:** To ensure that the management of the project can be based on a thorough understanding of how the project is developing.
 - 8.3.3 **Impact:** To show that the project creates value for money and that the target groups benefit
 - 8.3.4 **Learning process:** To promote an innovative approach of all stakeholders in and around the project so that the project, as well as the whole local economic development activities, become a dynamic and efficient tool.

REFERENCES AND FURTHER READING

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